

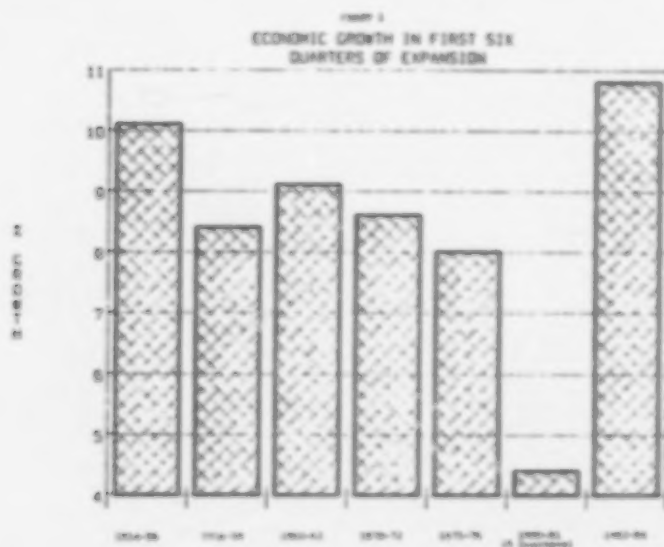
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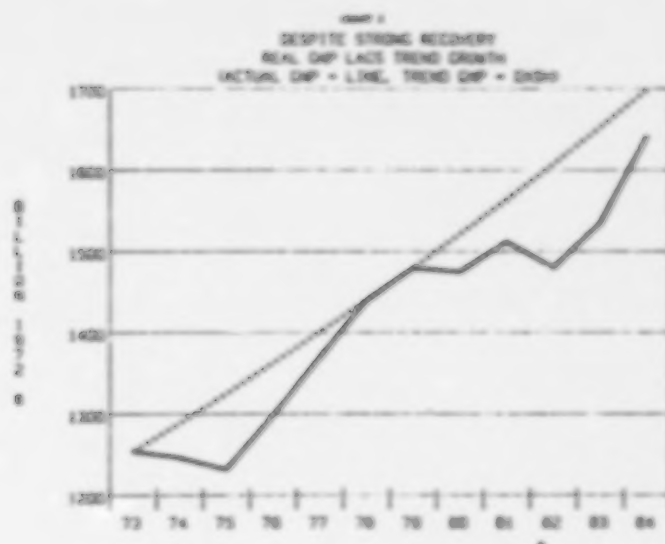
U.S. BUSINESS OUTLOOK, LONG-TERM

The 1983-84 economic recovery/expansion has been a beauty. From the pit of recession at the end of 1982 through the second quarter of 1984, the economy boomed more than 10%. As Chart 1 below shows, this growth rate is the best for any recovery in the past three decades.



But while the recent past looks good, a longer-term perspective puts things in a somewhat different light. Note in Chart 2 that even with the 1984





boom, inflation-adjusted gross national product (GNP) still lags behind trend growth in GNP. More specifically, note in Charts 3 through 6 on the next page that the past few years have seen declines (on average) in autos, housing, industrial production, and manufacturing capital investment.

This apparent decline in America's basic productive capability raises disturbing questions about the future of the U.S. economy, about future business prospects, and about future standards of living. This report will address the issue of U.S. industrial decline, offering a general perspective on manufacturing and short comments on individual industry prospects.

Further, this report will analyze industrial prospects within a broader economic framework that will importantly determine industrial chances no matter what individual industries do to help themselves. At the end of the report are forecasts of major economic indicators through the year 1995, with three scenarios for each indicator.

CHART 3
DOMESTIC SALES OF U.S.-ORIG. AUTOS
(MILLIONS OF UNITS)

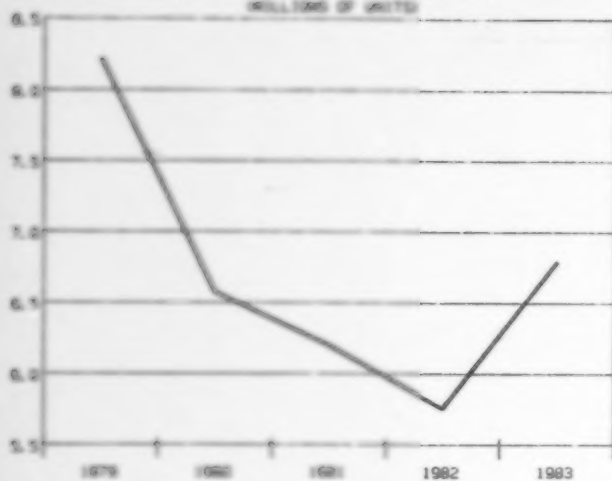


CHART 4
HOUSING STARTS
(MILLIONS OF UNITS)

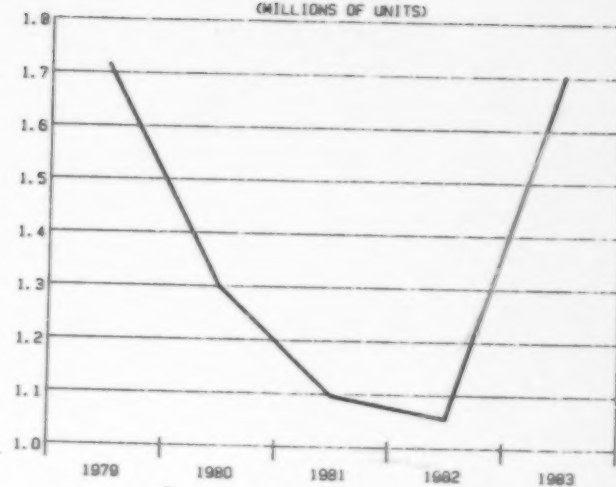


CHART 5
INDUSTRIAL PRODUCTION
(INDEX, 1987=100)

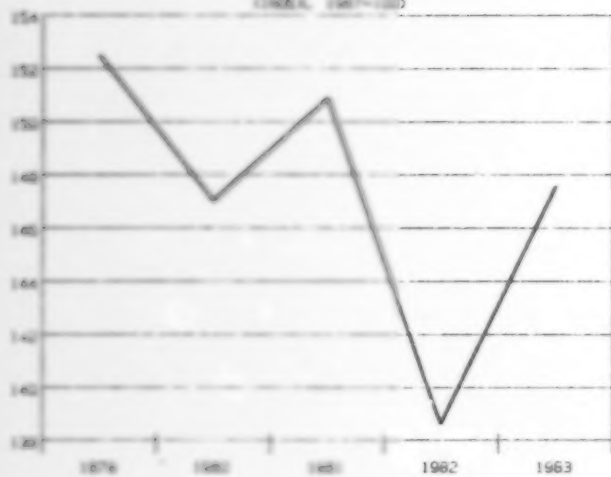
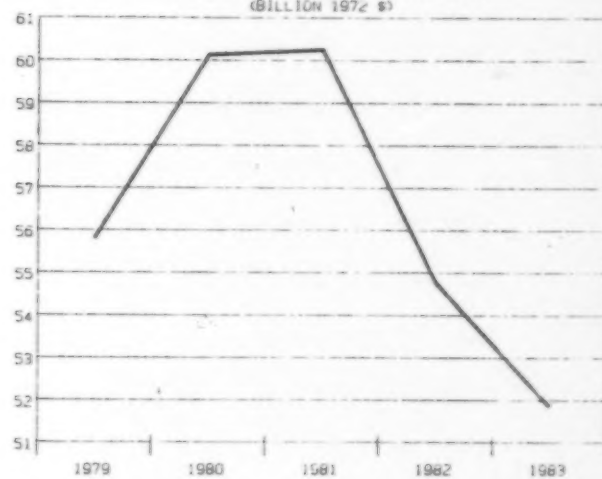


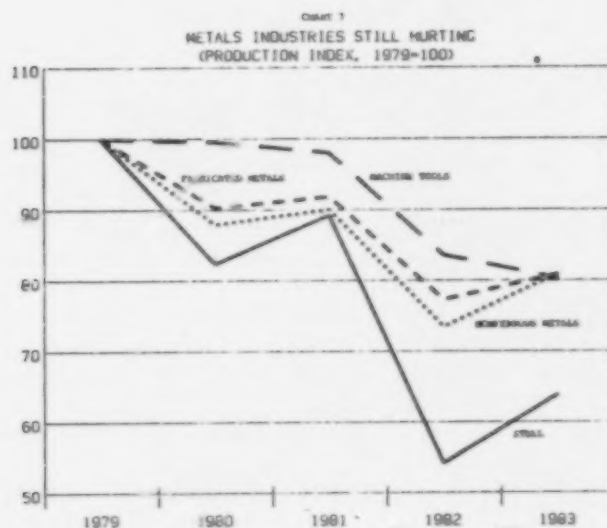
CHART 6
CAPITAL SPENDING BY MANUFACTURERS
(BILLION 1972 \$)



Don't Count Manufacturing Out in the Future

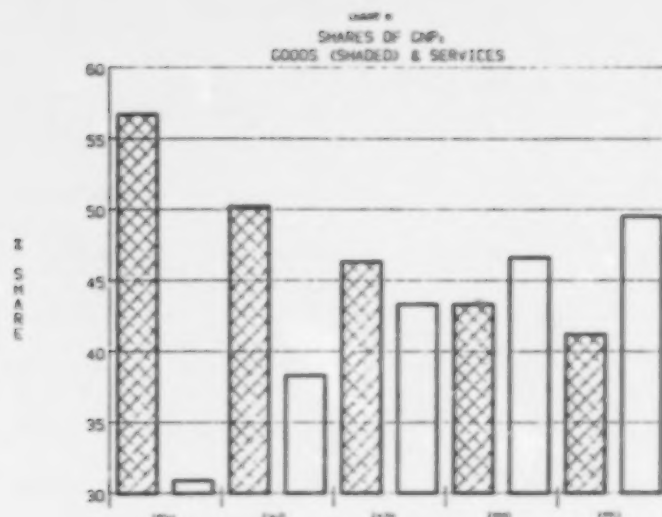
Charts 1 through 6 above show that though the 1983-84 economic recovery and expansion have been strong, important sectors of the economy have not even reached levels of activity attained five years ago. Hence the question: Is the economic glass half full or half empty?

If you're in an industry that produces physical goods, you may feel the glass is half empty; if you're in certain goods-producing industries--metals, for example--you may feel the glass is a lot emptier. (See Chart 7.)



If you produce services, however, the picture brightens, as illustrated in Chart 8. In the past three and a half decades, services have advanced from less than a third to about one-half of U.S. gross national product (GNP). (Not shown in the chart are structures, which accounted for some 12% of GNP in 1950 and 9% in 1983.)

Now in forecasting long-term economic conditions, it may be a pretty good idea to extrapolate from the past, especially when certain long-term trends seem well established. This forecasting method would logically project further substantial gains in services as a share of total U.S. output and



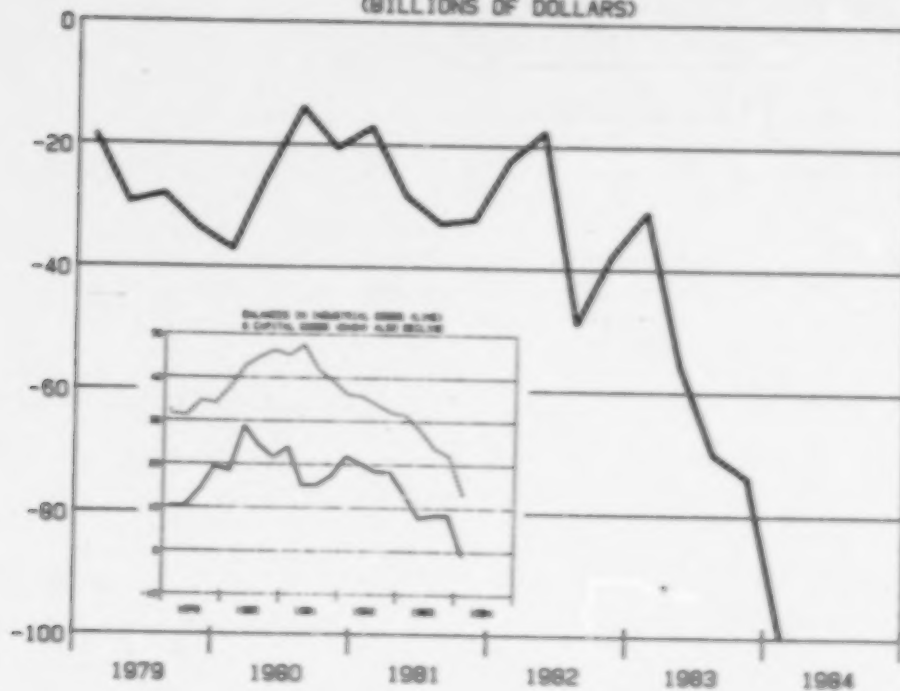
further relative and possibly absolute declines in manufacturing.

But this is not the line of attack taken here. On the contrary, from now on manufacturing is expected to hold its own. The key assumption: U.S. manufacturers in recent years have realized they are fighting for survival. Not only has the energy and ingenuity of Japanese and other Asian producers forced Americans to reassess the U.S.'s preeminent role in the world economy; in addition, as if to reinforce this lesson, the powerful upsurge of the dollar has made it even more difficult for American companies to compete against foreigners both at home and abroad. The outcome: A growing understanding by American businesses that the world economy is no longer their privileged bailiwick, as in the 1950s and 1960s.

Probably the main statistical indicator of growing foreign competition is the mammoth gap that has opened in the U.S. trade balance. Observe in Chart 9 that not only has the overall balance declined, but so have the traditionally strong balances in industrial materials (e.g., chemicals) and capital goods.

Since the growing deficit partly reflects increased vulnerability to economic forces outside U.S. boundaries, the implication might be that

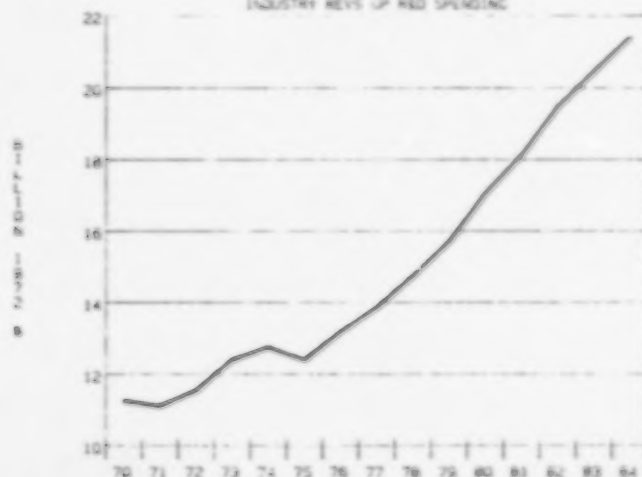
CHART 9
TRADE BALANCE WORSENS
(BILLIONS OF DOLLARS)



American manufacturers are becoming dinosaurs, dying off due to environmental change beyond their control.

But in some industries at least, the opposite seems to have occurred: The growing trade deficit plus growing foreign investment in the U.S. plus increasing competition from foreign multinationals in overseas markets have awakened these manufacturers. Hence several years ago many U.S. industrial began to pour more money into research and development. (See Chart 10.) And

CHART 10
INDUSTRY REVS UP R&D SPENDING



until the steep 1981-82 recession knocked their markets for a loop, manufacturers had been investing heavily in new plant and equipment. (From 1973 to 1980, inflation-adjusted capital spending by manufacturers zipped along at nearly a 6% average annual rate, compared to average long-run growth of about 3% from 1953 to 1983.)

Now, fueled by expansion--with the 1981 tax cuts as retrorockets--manufacturers have shown they are ready to renew heavy investing. In fact, inflation-adjusted investment in manufacturing has grown faster in the last year and a half than in any similar period of economic recovery in the past three decades. (See Table 1.)

Table 1. Manufacturing Investment Zooms in 1983-84

-% Change in Real Manufacturing Investment-
Five Quarters After Trough Compared to:

<u>Date of Trough</u> <u>(Year: Quarter)</u>	<u>Trough</u>	<u>Five Quarters</u> <u>Before Trough</u>
1954:2	4.0	-0.2
1958:1	-14.3	-28.9
1960:4	-4.7	11.5
1970:4	-9.8	-19.3
1975:1	-5.9	-2.7
1980:2	1.2	14.5
1982:4	12.6	-7.1

(At the same time, so as not to blow the investment surge out of proportion, it should be noted that investment in this cycle has a long way to climb back, because it got crunched so badly in the recession. Thus note the second column of Table 1, which shows that despite the sharp increase in manufacturers' capital spending, outlays are still 7% below the pre-recession level.)

What's more, although the rate of advance has slowed, industrial research and development (R&D) spending remains robust. Combining the continued R&D effort with the capital spending surge, it appears that manufacturing industries are making firm commitments to the long-term, a competitive strategy sadly lacking during much of the 1970s.

Table 2 compares this long-term commitment--measured by spending on capital goods and on R&D--during the past five years with the previous five years. For all manufacturing, the average growth rate of spending is about the same during the two periods, after taking out inflation. But while it is convenient to make neat 5-year comparisons, this particular comparison hides the fact that 1974-79 measures spending between an economic low point and a

Table 2. Commitment to the Long Run

Spending on Plant & Equipment and Research & Development (Average Annual Percent Change*)		
	1974-79	1979-84
Electrical Machinery	11.5%	14.8%
Rubber & Plastics	5.5	13.4
Instruments	13.3	12.5
Chemicals	10.6	11.3
Nonelectrical Machinery	12.5	10.4
Aerospace	18.6	10.3
Manufacturing Average	11.9	10.1
Average annual inflation	7.3	6.5
Adjusted for inflation	4.6	4.4
Nonferrous Metals	5.5	6.9
Food & Beverages	11.3	6.2
Autos, Trucks & Parts	13.8	4.7
Textiles	7.3	4.4
Paper	13.7	4.3
Steel	10.7	3.6
Fabricated Metals	8.7	3.6
Stone, Clay & Glass	14.8	1.1

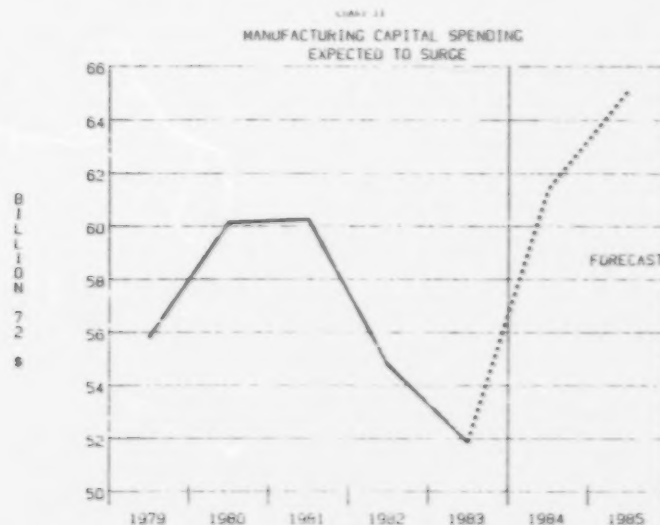
*Includes inflation

peak, while 1979-84 starts from a peak. The latter period also contained more quarters of recession. Hence the comparison cards are stacked in favor of the first period.

In other words, the table does not say that spending for long-term growth was the same in the two periods. Rather, it says that despite the adverse economic climate affecting most of the second period, longer-term thinking took hold in U.S. boardrooms.

Looking at plant and equipment spending alone since 1979 (see Chart 6 on page 3), that assertion may seem wholly without substance:

Inflation-adjusted manufacturing investment trended down from 1979 to 1983. Yet with investment roaring back in the past year, Chart 11 might present a more complete view of manufacturing investment than Chart 6.



Among manufacturing industries, it's clear from Table 2 that high-tech industries have made the strongest commitment to long-term growth. Hence, not surprisingly, these industries--and more generally, all the industries in the top half of the table--should reap the strongest growth in the next decade:

- Spurred by rapid market growth created through technological innovation, high-tech industries such as computers, electronic

components, instruments, and communications equipment have led the new industrial/research revolution in the U.S. These industries have been investing more than other industries, and they should continue to do so. Besides investing to keep up capacity and to keep up with state-of-the-art production processes, these industries will also invest heavily to maintain a technological edge over competition both at home and abroad. Maintaining that edge means both generating ideas (R&D) and putting those ideas into practice (plant and equipment).

- . The plastics industry is also expected to enjoy relatively rapid growth in the next decade as manufacturers increasingly substitute plastics for metals in their products, and as plastics-using equipment such as computers become even more prevalent throughout the economy.
- . If plastics use intensifies, demand for chemicals will also get a boost. Meanwhile, chemical firms are expected to remain committed to strong research plans to develop specialty chemicals, the source of new profits in a world where demand for commodity chemicals will grow only slowly and where resource-rich Saudi Arabia will soon come on line with large new petrochemical plants. Chemical capital investment, however, may not grow as quickly in the future as in the past since specialty chemicals are made in smaller quantities than commodity chemicals, and therefore may require less plant and equipment. At the same time, the nature of investment may shift increasingly to more sophisticated control equipment: If many chemical firms are de-emphasizing commodities and emphasizing specialties, the winners will be those who produce unique products or who produce common products at lowest cost; both strategies would presumably require the best available control and production equipment.
- . All of the modernizing in the next decade will not be accomplished by industries in the top part of Table 2, however. Industries in the bottom part, in general, got hit harder by the recession; hence if they want to regain a competitive footing they will have to modernize. These industries, by and large, have also been hardest hit by the super-strong U.S. dollar. Autos, steel, and textiles are the major examples here. The auto industry has reacted to stiffer foreign competition as well as changing consumer attitudes by focusing on cutting production costs via robotization and computerization. The industry now makes big profits at production levels once thought only mediocre. Part of the industry's recent success, of course, resulted from trade restrictions on Japanese autos. Thus to stay competitive after the restrictions are lifted, U.S. auto makers will have to keep research and modernization plans in high gear.
- . The two industries suffering most from foreign competition--textiles and steel--have also gone the protection route in order to survive. But in addition, when they have had the money, they have also spent on modernization. Beginning in the second half of the 1970s, the textile industry began to streamline operations with new equipment while at the same time closing outmoded plants. This trend is expected to continue, enabling the domestic industry to compete in certain lines with foreigners. The steel industry, within its

means, has invested in continuous casters and electric furnaces in order to cut costs. These moves, however, are still not enough to allow the domestic industry to compete against imports from Korea, Brazil, Argentina, and Japan. Hence the industry is seeking further government protection in exchange for further modernization. In the next decade, further consolidation of the steel industry is expected, with fewer large companies producing less steel with more modern plant and equipment at lower cost per ton.

- . Other industries in the bottom part of Table 2 are less subject to foreign competition than steel, autos, and textiles. But they, too, will be under pressure to invest for the long term, because they too will be competing in an economy more cost conscious than it was in the 1970s. Which means price increases will not be going through as easily as in the earlier era of higher inflation. Since these industries are also mature, it means markets will not be growing rapidly, thus giving further impetus to modernization as the way to boost profits in the 1980s and beyond.
- . In the 1980s and 1990s, all industries will be spurred to increase plant and equipment investment because the U.S. labor force will not be growing as quickly as in the 1960s and 1970s, when the baby boomers entered the work place in droves. Relatively fewer workers implies upward pressure on wages, which implies the cost of labor relative to capital will likely be rising. In the past decade, the opposite was the case. Hence the ratio of capital to labor--a key determinant of productivity--fell in the late 1970s. This relationship has been turning around in the 1980s, boosting productivity.

Will the Economy Cooperate With Industry's Plans?

The above analysis may point to relatively good growth rates for various industries for the rest of the decade. But the analysis looks only at what industries are doing for themselves. It ignores the external economic environment these industries must contend with; thus it ignores the great imponderables beyond these industries' control.

So even though many companies have adopted a longer-term outlook, external developments can turn the best-intentioned business plans into so much refuse.

One of the biggest imponderables in the immediate future--perhaps the longer-term future as well--is the federal deficit. True enough, Congress recently passed a three-year budget reduction package; but as major surgery on

the hemorrhage in the federal accounts, you can forget it. It's a band-aid.

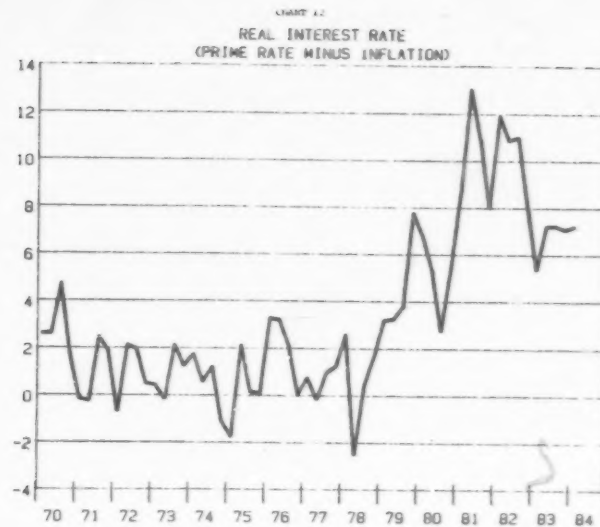
Even with this "down payment" on the deficit, the Office of Management and Budget (OMB) pegs the federal deficit at about \$180 billion in each of the next three next years. Perhaps a more important measure is the deficit as a share of GNP: OMB thinks it will be well over 4% of GNP through 1987 at least, compared to an historical average of 1%-2%. Data Resources Inc. (DRI) thinks the deficit will be more in the \$200 billion range per year--closer to 5% of GNP on average in 1984-87.

One response to these numbers might understandably be: So what, we've had huge deficits in the past two years, and look how good the recovery has been ... without a resumption of inflation. Which is true. But don't forget, big deficits are supposed to boost the economy in slack periods. After all, government demand for goods and services combined with tax cuts provide business and consumers with income.

The problem with this argument, which is fine as far as it goes, is that it ignores the impact of the deficit on interest rates. And it blithely assumes that with the unemployment rate falling quickly, and with factory operating rates rising, deficits will never cause inflationary pressure.

As for interest rates, they are extremely high, especially after factoring out inflation. One such "real" rate of interest is pictured in Chart 12.

To this point in the expansion, borrowers and lenders have in part made an end run around these high rates through adjustable rate mortgages (ARMs), which have financed more than half of all U.S. house purchases in some months of 1984. But as these low-interest ARMs begin to roll over, mortgagees will find themselves ARM-twisted into significantly higher monthly payments. Some home owners will default, damping banks' enthusiasm for these instruments in the future. Fewer people will qualify for mortgages; and housing starts will



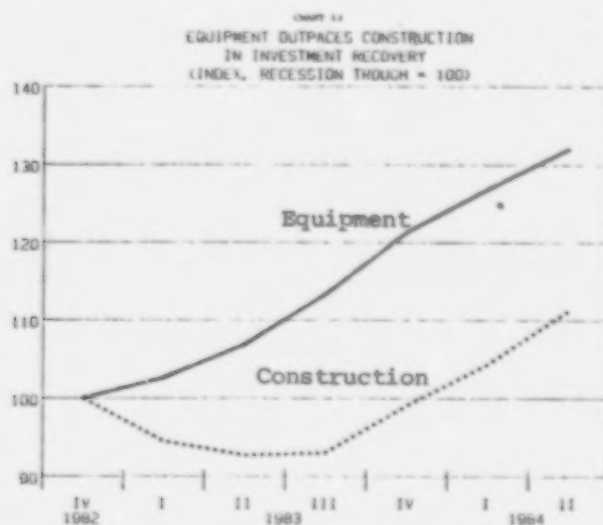
decline next year. Longer-term, relatively high interest rates are forecast to keep housing starts below where "normal" demand generated by population growth would push them.

Besides making end runs around brutish interest rates, consumers and business have had the muscle to plain run over them, the muscle being provided by gushing cash flow. In the case of business, rising cash flow resulted from higher sales coupled with more favorable tax laws. For consumers, it came from more jobs and lower inflation (allowing smaller pay raises to top inflation).

But corporate cash flow growth is already starting to slow. And job growth cannot continue to go on at the vigorous pace of the past year; what's more, at some point a tight economy will lead to rising prices that will eat up bigger chunks of pay raises. Interest rates will then become more of a foe.

Already, high rates have kept housing from attaining previous peaks. This despite the large number of people in prime house-buying age categories. Car buying, too, despite stretched-out payment plans, is far below the levels of a decade ago.

High interest rates probably also played an important role in keeping the structures side of capital investment down even as equipment investment soared in the first year of recovery: Buildings are longer-lived than equipment, hence borrowing at high rates entails many more years of large interest payments. Equipment and structures investment are compared in Chart 13.



The point is that the monster federal government deficits have already exacted a toll from the economy, although that toll has gotten ignored in the generally acclaimed success of the economic expansion.

The underlying assumption here is that, at a minimum, the deficits have made an inherently bad interest rate situation even worse. More specifically, it's probable the deficits have kept interest rates well above the rate of inflation (thus breaking an historical relationship). For without deficits where they are, the cash flow flood generated by the recovery coupled with a not ungenerous Federal Reserve Board policy would have pushed rates down much further. (Table 3 compares Fed policy--measured by money supply growth--in this and other economic expansions. The vociferous criticism of the Fed

Table 3. Fed Bashing Has Not Been Justified

-% Change in Money Supply-
First 5 Quarters of Recovery

<u>Recovery Period</u>	<u>M1*</u>	<u>M2*</u>
1960-62	3.6%	9.4%
1970-72	8.8	16.9
1975-76	7.4	17.1
1980-81	10.9	12.8
1982-84	12.0	14.0
Average	8.5	14.0

*M1 includes currency, demand deposits, travelers' checks, and other checkable deposits. M2 includes M1 plus savings and money market accounts, overnight FPs and Eurodollars.

notwithstanding, it seems hard to fault the monetary managers for stinginess in 1982-84.)

The essential point about the deficit is that it gobbles up a huge share of the savings the economy manages to generate. Look at Table 4 to see how the government in recent years has assumed the unprecedented role of borrower of first resort. What's worse, this role will not soon be abandoned, as suggested by the budget deficit projections of OMB and DRI.

Table 4. Federal Government Deficit Grows as Share of Private Saving

<u>Period Average</u>	<u>Deficit as % of Saving</u>
1950-59	surplus
1960-69	1.8%
1970-79	10.5
<u>Year</u>	
1980	14.1
1981	12.2
1982	28.2
1983	32.2
1984	28.0

All that government borrowing not only exerts constant pressure on financial markets, keeping interest rates up for straight supply-and-demand reasons. It also instills tremendous fear and trembling in the credit markets, thus pushing up the risk premium that investors demand for lending their money in a period they think could become highly inflationary.

And irony of ironies, as interest rates remain high or go higher, federal interest payments go higher, making the deficit yet bigger.

In other words, one of the big imponderables looming over company business plans is the impact of the deficit on interest rates, hence the impact of interest rates on consumer and business big-ticket expenditures, not to mention the impact on the value of the dollar.

Another possible destabilizer of U.S. credit markets during the next decade is the world debt crisis. Specifically, less developed countries owe some \$300 billion to U.S. banks, with much of the money owed to about a dozen money center banks. In most cases, debtor nations have ceased making payments on the principal of their outstanding loans while continuing to pay the interest due. In some cases, though, nations have even fallen into arrears on their interest payments.

As far as the U.S. economy is concerned, the serious questions concern the impact of the debt crisis on interest rates, the stability of the domestic banking system, and the level of overall economic activity.

Confidence in the U.S. banking system has already been shaken by the debt crisis. Witness, for example, the fall in Manufacturers Hanover stock when rumor spread in mid-1984 that its foreign loans were on the rocks. Witness, too, the cracking of Continental Illinois, which had made large loans to developing nations (as well as bad domestic loans). Among analysts and investors, the belief may be growing that debtor nations will never be able to repay the huge sums they have borrowed from U.S. banks.

Thus to protect themselves and to recoup losses, bankers may tack bigger risk premiums onto future loans to debtor nations, and onto domestic loans as well. Higher rates, however, would only further aggravate the debt crisis and lead to greater instability. Another option, which international lenders seem to have adopted, is to cut back on loans to developing countries. Such a tactic, by adding funds to U.S. credit markets, could benefit the domestic economy by putting downward pressure on interest rates in the U.S. But, on the other hand, lack of funds could then undermine debtor country economies, causing them to default outright on their loans.

No matter what course banks take, therefore, it could lead to explicit or implicit repudiation of debt, hence to further tottering of some U.S. banks. The potential danger to the economy could perhaps be muted, though, if the Federal Reserve Board convinces banks to cap interest rates on foreign loans. For its part, the Fed may try to keep interest rates from rising too high for fear of the effect on debtor countries. As with Continental Illinois, the government could also call in the Federal Deposit Insurance Corporation to shore up banks, even to the point of owning them. Another tactic would be to contribute more funds to the International Monetary Fund and World Bank, to shore up the borrowing countries. That, however, would add to government spending and the U.S. deficit.

Whatever gambits are employed, the debt crisis at best threatens to keep financial market nerves all ajitter. At worst, the crisis threatens bank failures and a credit crunch. The overall impact of the crisis, therefore, will probably be to keep interest rates higher than they would be in the absence of the ticking debt bomb.

Summary and Conclusion

The conclusion is that due in part to high interest rates, growth of the U.S. economy during the next few years will be subpar. Hence ambitious growth plans being written by some companies will not be realized. The other side of the coin is that money for R&D and plant and equipment investment will be expensive, forcing some companies to trim some plans. With federal borrowing continuing to eat up 4%-5% of GNP, that is, private industry will have a hard time attaining all its research and investment goals. (It's conceivable that consumers could save more in the future, thus putting downward pressure on interest rates and making credit more readily available. Under those assumptions, investment and overall economic growth would be higher.)

Besides high interest rates, slower growth of the work force will also cause the economy to slow compared to past performance. In other words, though business is expected to emphasize capital investment during the next decade, investment--hence productivity--is not expected to be rapid enough to offset the slowdown in labor force growth.

If, as a worst case, government deficits remain humongous--i.e., if Washington fails to act decisively within the next couple of years--then interest rates could remain extremely high despite a slowdown in economic growth. Instead of the old stagflation--the combination of slow growth and rising inflation, we could have stagration--slow growth and high interest rates--for a considerable period.

The three sets of assumptions for the overall economy, then, are:

- . Middle-of-the-Road--government deficits subside though remaining large; interest rates decline from current heights but remain high by historical standards; industry boosts investment and research, improves its international competitive position, and reduces calls for protection.

- Pessimistic--the government fails to control the budget in the next couple of years; hence the government continues to garner the lion's share of society's savings, keeping inflation-adjusted interest rates at historical highs or even higher; hence industry is unable to get sufficient funds to attain its research and investment goals; productivity falters, and the economy sputters; industry seeks increasing protection against foreign competition.
- Optimistic--personal saving rises beyond rates of the past decade, supplying more funds to credit markets, pushing interest rates down; industry is thus able to obtain full funding for investment and research projects; international competitiveness improves markedly.

The numbers attached to these three sets of assumptions are presented at the end of this report. Table 5 quantifies the differences between the three scenarios in summary form.

Table 5. The Three Scenarios in Summary

	Annual Average	
	----Real % Change----	
	<u>1983-95</u>	<u>1984-95</u>
<u>Pessimistic</u>		
Gross National Product	2.4%	2.1%
Consumer Spending	2.2	1.9
Business Capital Investment	3.6	2.6
Industrial Production	3.3	2.5
Inflation	7.3	7.5
<u>Middle</u>		
Gross National Product	3.1	2.8
Consumer Spending	2.7	2.6
Business Capital Investment	5.1	4.3
Industrial Production	4.1	3.5
Inflation	5.7	5.9
<u>Optimistic</u>		
Gross National Product	3.7	3.2
Consumer Spending	3.3	3.2
Business Capital Investment	6.4	5.6
Industrial Production	4.9	4.3
Inflation	4.8	4.9

Note that in all three scenarios, business capital investment is projected to be the fastest growing major sector of the economy. But realize also that overall growth of the U.S. economy in the past thirty years has averaged more than 3% per year; and only in the optimistic scenario does the economy reach that goal (using the 1984-95 period for comparison to eliminate the effect of the recovery).

Hence the decade ahead is viewed as a potential rebuilding period, a period when U.S. manufacturing restructures and renews itself. At the same time, the period will witness economic problems external to manufacturing--federal deficits, slowdown in labor force growth, and debt-inspired uncertainty in the financial system. As a result, the overall economy will falter from time to time; and manufacturers will find it difficult to achieve all their goals.

MIDDLE-OF-THE-ROAD FORECAST

History	-----Billions of Dollars-----				-----Billions of 1972 Dollars-----				Inflation (GNP Deflator, 1972=100)
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment			
1950	286.5	192.0	27.3	534.8	337.3	50.0	53.5		
1960	506.5	324.9	48.5	737.2	452.0	66.9	68.7		
1970	992.7	621.7	103.9	1,085.6	672.1	113.9	91.4		
1971	1,077.7	672.2	107.9	1,122.4	696.8	112.2	96.0		
1972	1,185.9	737.0	121.0	1,185.9	737.0	121.0	100.0		
1973	1,326.4	812.0	143.3	1,254.3	767.9	138.1	105.7		
1974	1,434.2	888.1	156.6	1,246.3	762.8	135.7	115.1		
1975	1,549.2	976.4	157.8	1,231.7	779.4	119.3	125.7		
1976	1,718.0	1,084.3	174.1	1,298.2	823.1	125.6	132.3		
1977	1,918.3	1,204.5	205.3	1,369.7	864.4	140.3	140.0		
1978	2,163.8	1,346.5	248.9	1,438.5	903.2	158.3	150.4		
1979	2,417.8	1,507.2	290.2	1,479.4	927.6	170.0	163.4		
1980	2,631.7	1,668.1	308.8	1,475.0	931.8	165.8	178.4		
1981	2,957.8	1,849.1	353.9	1,512.2	950.5	175.0	195.6		
1982	3,069.2	1,984.9	349.6	1,480.0	962.3	166.9	207.4		
1983	3,304.8	2,155.9	352.9	1,534.7	1,009.2	171.0	215.3		
Forecast									
1984	3,647.7	2,350.7	402.0	1,627.9	1,061.0	193.2	224.0		
1985	3,912.4	2,528.0	443.8	1,663.6	1,088.0	203.7	235.2		
1986	4,256.2	2,728.2	501.6	1,713.1	1,113.7	216.5	248.4		
1987	4,654.4	2,957.2	566.7	1,772.7	1,144.1	229.4	262.5		
1988	5,100.5	3,219.5	629.4	1,836.5	1,179.3	240.0	277.7		
1989	5,572.5	3,505.8	694.6	1,894.6	1,213.8	249.2	294.1		
1990	6,081.8	3,817.2	766.3	1,949.7	1,246.3	258.2	311.9		
1991	6,642.1	4,152.5	845.5	2,005.6	1,278.0	267.4	331.1		
1992	7,244.1	4,512.2	931.0	2,059.5	1,309.4	277.3	351.7		
1993	7,883.9	4,895.4	1,022.5	2,110.9	1,339.8	287.4	373.4		
1994	8,564.9	5,303.5	1,117.6	2,161.7	1,369.8	297.1	396.2		
1995	9,297.6	5,742.5	1,216.9	2,213.2	1,399.8	306.3	420.1		

MIDDLE-OF-THE-ROAD FORECAST

History	Industrial Production (Index, 1967=100)	Population (Millions)	Housing Starts* (Thousands)	Civilian Employment (Millions)
1950	44.9	152.3	1,899.3	58.9
1960	66.1	180.7	1,256.0	65.8
1970	107.8	205.1	1,434.8	78.7
1971	109.6	207.6	2,035.6	79.4
1972	119.7	209.9	2,360.7	82.1
1973	129.7	211.9	2,043.9	85.1
1974	129.3	213.9	1,331.9	86.8
1975	117.8	216.0	1,159.8	85.8
1976	130.4	218.1	1,535.0	88.8
1977	138.1	220.3	1,961.8	92.0
1978	146.1	222.6	2,000.6	96.0
1979	152.5	225.1	1,717.3	98.8
1980	147.0	227.6	1,300.3	99.3
1981	150.9	229.8	1,096.3	100.4
1982	138.6	232.0	1,056.3	99.5
1983	147.6	234.2	1,703.5	100.8
<u>Forecast</u>				
1984	164.6	236.4	1,816.4	105.1
1985	169.9	238.7	1,568.2	107.2
1986	176.1	240.9	1,717.7	109.0
1987	183.9	243.2	1,867.7	111.0
1988	192.7	245.4	1,898.3	113.1
1989	200.4	247.6	1,845.1	114.8
1990	207.1	249.7	1,769.4	116.1
1991	214.3	251.8	1,736.0	117.4
1992	221.1	253.9	1,711.9	118.7
1993	227.5	255.9	1,703.8	119.8
1994	233.6	257.8	1,672.8	120.9
1995	240.1	259.6	1,628.0	122.1

PESSIMISTIC FORECAST

History	-----Billions of Dollars-----			-----Billions of 1972 Dollars-----			Inflation (GNP Deflator, 1972=100)
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	
1950	286.5	192.0	27.3	534.8	337.3	50.0	53.5
1960	506.5	324.9	48.5	737.2	452.0	66.9	68.7
1970	992.7	621.7	103.9	1,085.6	672.1	113.9	91.4
1971	1,077.7	672.2	107.9	1,122.4	696.8	112.2	96.0
1972	1,185.9	737.0	121.0	1,185.9	737.0	121.0	100.0
1973	1,326.4	812.0	143.3	1,254.3	767.9	138.1	105.7
1974	1,434.2	888.1	156.6	1,246.3	762.8	135.7	115.1
1975	1,549.2	976.4	157.8	1,231.7	779.4	119.3	125.7
1976	1,718.0	1,084.3	174.1	1,298.2	823.1	125.6	132.3
1977	1,918.3	1,204.5	205.3	1,369.7	864.4	140.3	140.0
1978	2,163.8	1,346.5	248.9	1,438.5	903.2	158.3	150.4
1979	2,417.8	1,507.2	290.2	1,479.4	927.6	170.0	163.4
1980	2,631.7	1,668.1	308.8	1,475.0	931.8	165.8	178.4
1981	2,957.8	1,849.1	353.9	1,512.2	950.5	175.0	195.6
1982	3,069.2	1,984.9	349.6	1,480.0	963.3	166.9	207.4
1983	3,304.8	2,155.9	352.9	1,534.7	1,009.2	171.0	215.3
Forecast							
1984	3,660.8	2,358.2	404.3	1,630.4	1,062.4	194.0	224.5
1985	3,895.7	2,534.4	439.4	1,637.2	1,080.2	200.6	238.0
1986	4,105.9	2,693.7	449.7	1,628.9	1,088.4	194.5	252.0
1987	4,522.8	2,950.1	488.5	1,691.0	1,125.1	199.4	267.4
1988	4,972.6	3,226.7	537.8	1,741.1	1,152.1	205.9	285.6
1989	5,484.9	3,539.1	593.8	1,790.3	1,178.1	212.0	306.3
1990	6,060.7	3,894.4	662.9	1,835.9	1,202.5	218.8	330.1
1991	6,707.0	4,285.4	744.3	1,878.0	1,223.4	226.1	357.1
1992	7,441.6	4,729.5	838.3	1,920.9	1,245.8	234.2	387.4
1993	8,260.9	5,224.0	944.9	1,961.9	1,267.3	242.4	421.0
1994	9,177.1	5,774.7	1,063.5	2,003.3	1,288.7	250.2	458.0
1995	10,206.7	6,389.6	1,194.9	2,045.7	1,310.0	257.4	498.9

PESSIMISTIC FORECAST

History	Industrial Production (Index, 1967=100)	Population (Millions)	Housing Starts* (Thousands)	Civilian Employment (Millions)
1950	44.9	152.3	1,899.3	58.9
1960	66.1	180.7	1,256.0	65.8
1970	107.8	205.1	1,434.8	78.7
1971	109.6	207.6	2,035.6	79.4
1972	119.7	209.9	2,360.7	82.1
1973	129.7	211.9	2,043.9	85.1
1974	129.3	213.9	1,331.9	86.8
1975	117.8	216.0	1,159.8	85.8
1976	130.4	218.1	1,535.0	88.8
1977	138.1	220.3	1,961.8	92.0
1978	146.1	222.6	2,000.6	96.0
1979	152.5	225.1	1,717.3	98.8
1980	147.0	227.6	1,300.3	99.3
1981	150.9	229.8	1,096.3	100.4
1982	138.6	232.0	1,056.3	99.5
1983	147.6	234.2	1,703.5	100.8
Forecast				
1984	165.1	236.4	1,842.3	105.3
1985	165.8	238.7	1,311.9	106.7
1986	160.2	240.9	1,272.1	105.4
1987	168.6	243.2	1,521.6	107.2
1988	175.8	245.4	1,623.4	108.9
1989	182.7	247.6	1,673.2	110.3
1990	189.1	249.7	1,633.3	111.5
1991	194.9	251.8	1,600.8	112.4
1992	200.7	253.9	1,566.4	113.2
1993	206.2	255.9	1,542.2	114.0
1994	211.5	257.8	1,505.1	114.8
1995	217.1	259.6	1,462.5	115.6

OPTIMISTIC FORECAST

History	-----Billions of Dollars-----				-----Billions of 1972 Dollars-----				Inflation (GNP Deflator, 1972=100)
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment			
1950	286.5	192.0	27.3	534.8	337.3	50.0			53.5
1960	506.5	324.9	48.5	737.2	452.0	66.9			68.7
1970	992.7	621.7	103.9	1,085.6	672.1	113.9			91.4
1971	1,077.7	672.2	107.9	1,122.4	696.8	112.2			96.0
1972	1,185.9	737.0	121.0	1,185.9	737.0	121.0			100.0
1973	1,326.4	812.0	143.3	1,254.3	767.9	138.1			105.7
1974	1,434.2	888.1	156.6	1,246.3	762.8	135.7			115.1
1975	1,549.2	976.4	157.8	1,231.7	779.4	119.3			125.7
1976	1,718.0	1,084.3	174.1	1,298.2	823.1	125.6			132.3
1977	1,918.3	1,204.5	205.3	1,369.7	864.4	140.3			140.0
1978	2,163.8	1,346.5	248.9	1,438.5	903.2	158.3			150.4
1979	2,417.8	1,507.2	290.2	1,479.4	927.6	170.0			163.4
1980	2,631.7	1,668.1	308.8	1,475.0	931.8	165.8			178.4
1981	2,957.8	1,849.1	353.9	1,512.2	950.5	175.0			195.6
1982	3,069.2	1,984.9	349.6	1,480.0	963.3	166.9			207.4
1983	3,304.8	2,155.9	352.9	1,534.7	1,009.2	171.0			215.3
Forecast									
1984	3,643.2	2,349.2	404.9	1,627.8	1,061.2	194.6			223.8
1985	3,932.8	2,522.5	460.9	1,683.6	1,091.1	211.9			233.6
1986	4,297.2	2,719.3	536.6	1,751.3	1,120.8	231.7			245.3
1987	4,716.4	2,937.9	619.7	1,824.4	1,153.0	250.5			258.5
1988	5,182.8	3,191.9	702.2	1,900.7	1,193.8	267.2			272.6
1989	5,657.4	3,463.6	780.7	1,970.7	1,235.8	280.9			287.0
1990	6,157.4	3,758.5	860.8	2,040.2	1,279.4	293.8			301.8
1991	6,683.4	4,067.7	942.6	2,108.7	1,322.1	306.1			316.9
1992	7,230.5	4,392.5	1,026.4	2,175.9	1,364.8	318.6			332.3
1993	7,804.4	4,733.2	1,111.4	2,243.4	1,407.8	330.9			347.8
1994	8,404.9	5,089.7	1,197.2	2,312.1	1,451.5	343.2			363.5
1995	9,041.4	5,466.5	1,285.6	2,382.9	1,495.7	355.6			379.4

OPTIMISTIC FORECAST

<u>History</u>	<u>Industrial Production</u> (Index, 1967=100)	<u>Population</u> (Millions)	<u>Housing Starts*</u> (Thousands)	<u>Civilian Employment</u> (Millions)
1950	44.9	152.3	1,899.3	58.9
1960	66.1	180.7	1,256.0	65.8
1970	107.8	205.1	1,434.8	78.7
1971	109.6	207.6	2,035.6	79.4
1972	119.7	209.9	2,360.7	82.1
1973	129.7	211.9	2,043.9	85.1
1974	129.3	213.9	1,331.9	86.8
1975	117.8	216.0	1,159.8	85.8
1976	130.4	218.1	1,535.0	88.8
1977	138.1	220.3	1,961.8	92.0
1978	146.1	222.6	2,000.6	96.0
1979	152.5	225.1	1,717.3	98.8
1980	147.0	227.6	1,300.3	99.3
1981	150.9	229.8	1,096.3	100.4
1982	138.6	232.0	1,056.3	99.5
1983	147.6	234.2	1,703.5	100.8
<u>Forecast</u>				
1984	164.9	236.4	1,890.5	105.3
1985	174.4	238.7	1,884.6	108.5
1986	185.1	240.9	1,962.9	111.5
1987	196.0	243.2	2,031.1	114.3
1988	206.7	245.4	2,019.8	116.8
1989	215.1	247.6	1,970.3	118.9
1990	222.8	249.7	1,903.4	120.9
1991	230.6	251.8	1,881.2	122.9
1992	238.1	253.9	1,869.0	124.7
1993	246.0	255.9	1,874.1	126.5
1994	254.2	257.8	1,853.6	128.3
1995	263.1	259.6	1,817.1	130.3

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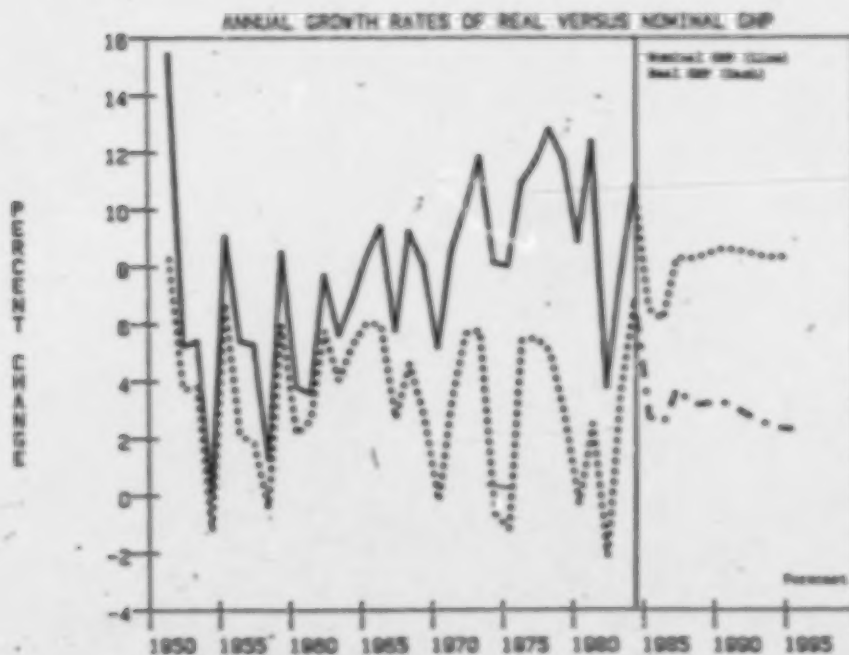
August, 1985

U.S. BUSINESS OUTLOOK, LONGTERM

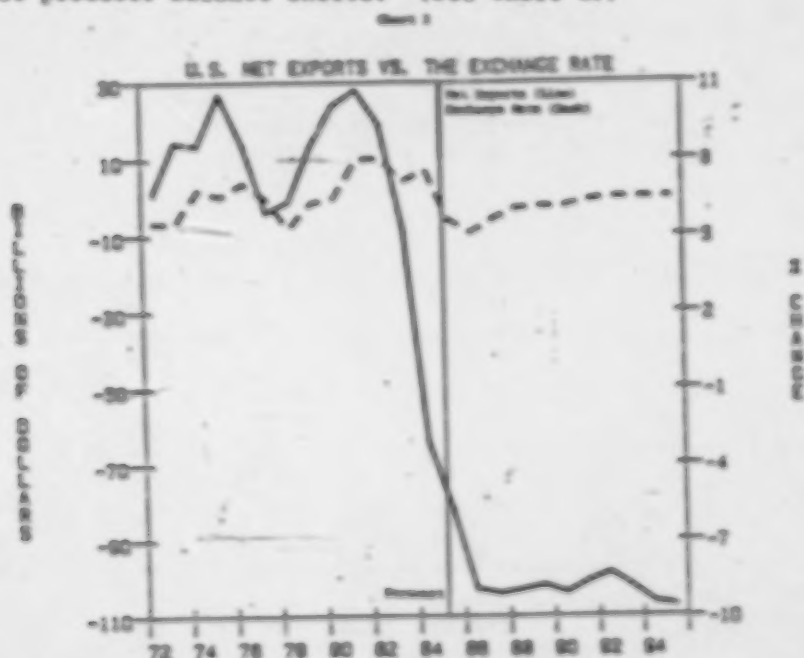
The U.S. economy may very well have its best days behind it. The 1983-84 economic recovery and expansion, vigorous as it was, has ushered in a new era of slowing growth and dimming economic prospects.

Consider this: From 1959 to 1984, real gross national product (GNP) grew at an average annual rate of 3.4%. - According to the most likely trend path of the economy over the next decade, real GNP will only grow at a 2.9% average annual rate. (See Chart 1.)

Chart 1

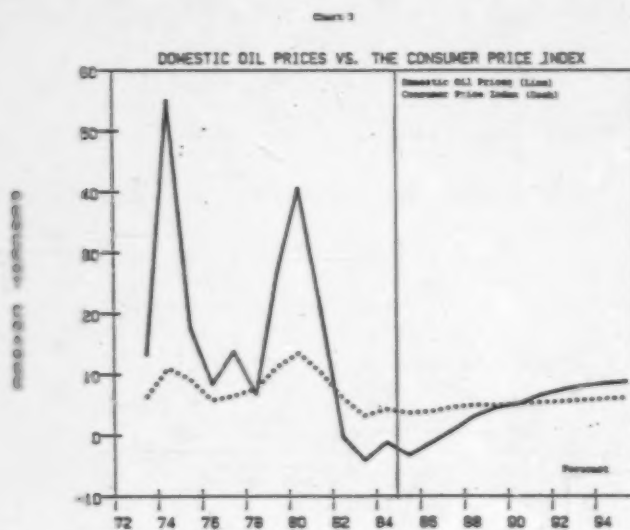


Blame for less economic vigor in the years to come falls on quite a few shoulders. Not only are slowing population growth, shifting demographics, and changing household formation trends fundamental variables that will continue to alter the structure of the U.S. economy. Other variables with radically different parameters than any the economy had ever experienced in the past will also be an inextricable part of the economic future. These include, of course, the seemingly untamable federal budget deficit and terminally high interest rates. An abnormally high dollar (and the resulting lopsided trade deficit) has also had a profound effect on U.S. prospects: Developing nations' exports are edging domestic manufacturers out of their own markets in part due to an overvalued dollar; interest payments (let alone the principal) by Latin American debtor countries have become unmanageable because they must be paid in expensive U.S. currency, giving rise to much uncertainty in U.S. financial markets; and stunted U.S. export markets are putting a crimp in many domestic producer balance sheets. (See Chart 2.)



Despite these dismal doings of the economy, there is at least one subject on which the long-term outlook is favorable--inflation. The muscle OPEC

asserted over international oil markets has turned to flab as growth in energy demand plunged, forcing the cartel to make sharp price cuts to keep wells in business. Hence, the rampant inflation fueled by rising energy costs in the seventies and early eighties is unlikely to reignite in the next decade. And even though U.S. manufacturers could live without the clamp cheaper foreign product puts on profit margins, the consumer price index in the next decade has pretty much been relegated to just over 5% annually--a far cry from the 8.5% average rate between 1973 and 1984. (See Chart 3.)



There is, then, a plethora of shifting economic agents that raise complex questions for companies trying to get ahead in today's business environment. For example, if the exchange rate can be tamed enough to give U.S. firms a fair share in the international marketplace, will internal economic conditions allow companies to beef up productivity enough to take advantage of it? And with the composition of the American population undergoing radical changes, just what industries will benefit--and be injured--by the shift?

In order to facilitate discussion of these questions, the long-term outlook on the U.S. economy is divided into four parts. The first takes a

broad view of the economy in an international perspective, discussing the effect of factors external to U.S. business and what implications these factors hold for the future. The second section focuses on the U.S. economic climate and to what extent it will nurture U.S. companies. The third section takes a more microscopic view of the economy, examining it in terms of shifting demographics, consumer spending patterns, and what these trends mean to individual industries. Finally, the last section tests alternative scenarios for the economy and how they alter the forecast.

Section I

The World Economy: Implications for U.S. Prospects

More than ever, U.S. economic prospects are inextricably tied to international economic conditions. In 1973-74, it was a handful of Arabian oil sheiks who ignited a decade of frenetic hikes in energy costs, massive inflation, havoc in international currency markets, and not least of all, gas lines. In 1982, it was the incessant increases in the value of the U.S. dollar (climbing since 1980) that began to seriously disrupt the usually calm waters of overseas trade. From a \$ 28 billion trade surplus in 1981, U.S. net exports of goods and services fell to negative \$ 64 billion in 1984. In merchandise trade alone, the trade surplus had eroded to -\$108 billion by 1984 from a deficit of \$24 billion in 1980. And not only has the merchandise trade balance taken a precarious toppling. From nearly \$150 billion in 1982, U.S. net foreign investment* slipped to less than \$10 billion by the close of 1984. With the dollar going strong into the new year, 1985 will mark the first time in modern American history that the U.S. net foreign investment figure will have a minus sign in front of it. In other words, after being the world's largest creditor nation, the overwhelming effect the dollar's strength is having on capital markets will transform the U.S. into one of the world's major debtor nations.

The 45% appreciation of the U.S. dollar since 1980 has had effects on both the debit and credit sides of the economy's balance sheet. On the one hand, U.S. manufacturing has certainly been put through the wringer. For example:

- * From 1980 to 1984, imports have upped their share of the U.S. goods market from 15.6% to 19%.

- * In the same period, imports have accounted for about 40% of the increase in consumer spending generated by the economic recovery.

But on the other hand, the massive inflow to the U.S. of foreign capital has helped finance the federal budget deficit, allowing private consumption and investment to increase despite the heavy government borrowing that would have normally crowded it out through higher interest rates.

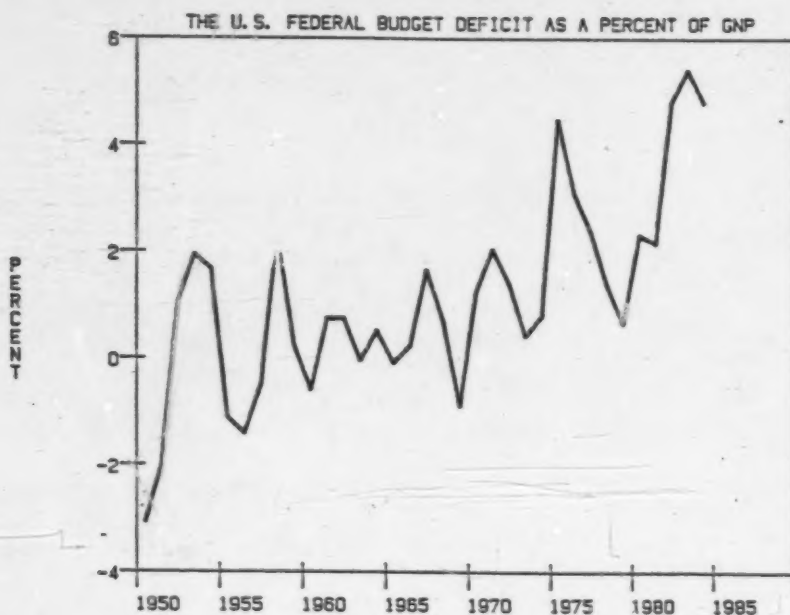
Clearly, the state in which the economy finds itself today is not in equilibrium, and some sort of return to normalcy should be expected. However, the exchange rate, the pivotal factor in this unnatural balancing act, cannot be expected to drop drastically for several reasons.

Rather than being built on speculative fluctuations, the rapid appreciation and enduring strength of the U.S. dollar has been based on a solid economic foundation. A large part of the dollar's attractiveness to foreign investors has come about through high interest rates--the hearty return on invested dollars fueled by flamboyant federal spending. (See Charts 4 and 5.)

The strength of the economic recovery has also added to the dollar's merits in the eyes of foreigners. The U.S. economy has had such a vigorous recovery, in fact, that the Organization for Economic Cooperation and Development (OECD) estimates that of all the growth experienced by developed countries since 1983, 70% is directly attributable to U.S. demand stimulus. Other less quantitative measures also come into play, however, such as

political stability and the pro-business attitude of the current

Chart 4

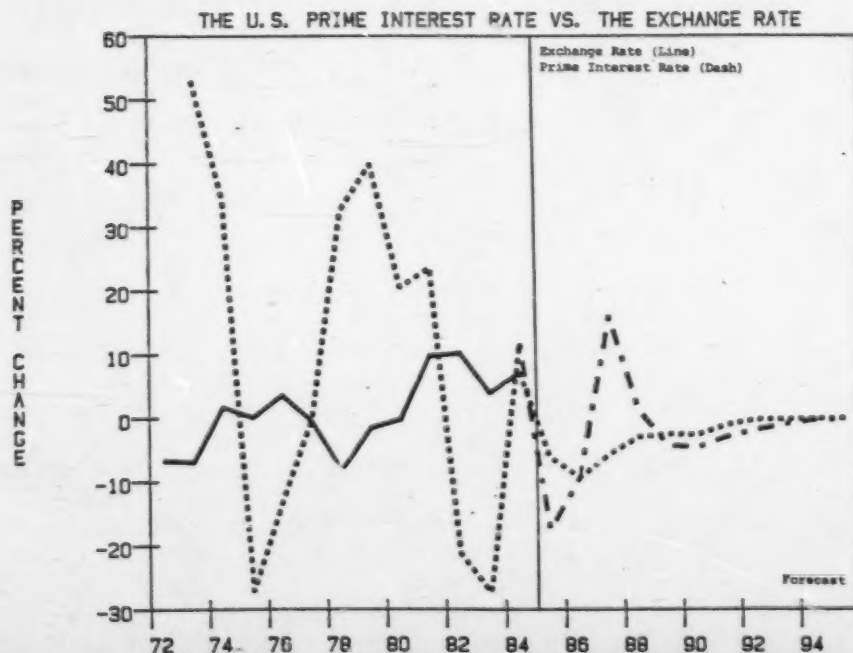


administration.

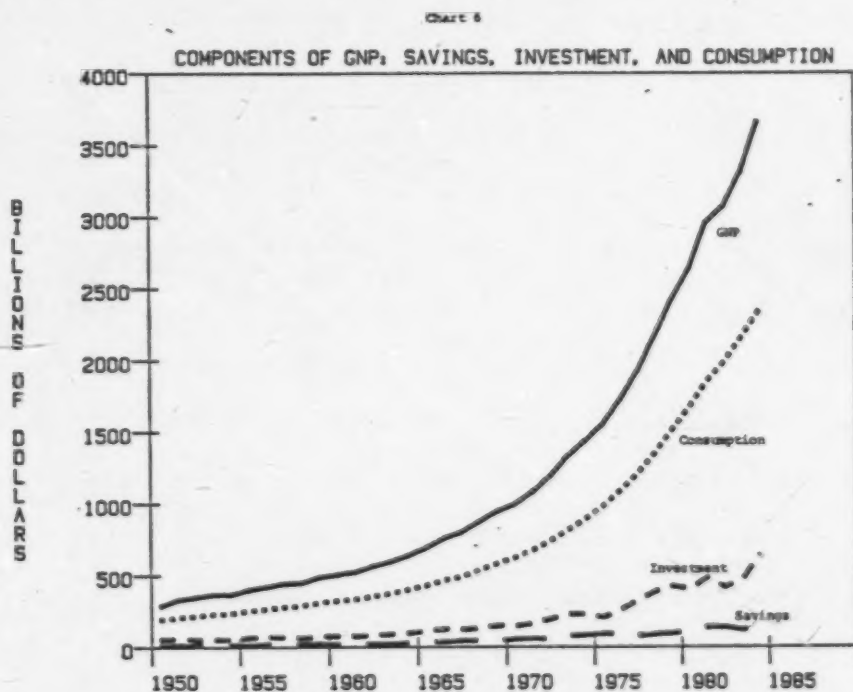
Hence, the fall in the U.S. exchange rate needed to revitalize the economy can come about only as a result of a drop in interest rates. And a drop in interest rates can come about only as a result of a reduction in the federal budget deficit--or a recession.

As it stands now the economy could very well be headed for trouble. Even

Chart 5



though falling interest rates have done a significant job in lowering the exchange rate over recent months, the signal may be more ominous than optimistic. For example, currently falling interest rates reflect sagging business investment and a weakening economy rather than lower government borrowing and permanent action on the federal deficit--the major driving force behind blockbuster interest rates. (See Chart 5.) So, while falling interest rates and a weaker economy have done and will continue to do something to drive off foreign investment and imports, if the government doesn't moderate its spending significantly it will be domestic manufacturers and consumers who end up paying the piper via another U.S. recession. At this juncture, then, the U.S. economy is juggling the burdensome federal budget deficit and the equally burdensome trade deficit.



Section II

Internal Injuries: A Catch 22 For the Economy

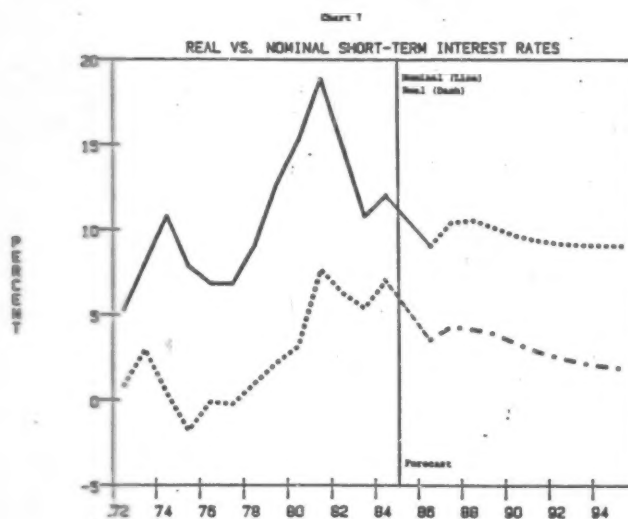
With the government continuing to draw substantial lifeblood from the economy's financial markets and with the exchange rate falling, a number of undesirable effects could very well become more prominent: Private and public competition for funds could ultimately light a fire under interest rates as the outflow of foreign capital tightens the supply of loanable funds; as U.S. manufacturers regain their position in domestic and foreign markets, higher priced American merchandise will take up more room on retail shelves, and consumer activity will ebb; and as competitive pressures between foreign and domestic manufacturers ease off, prices will rise. Ultimately, however, the economy will run full circle as the higher interest rates shore up exchange rates--and eventually put U.S. companies at a competitive disadvantage again.

In brief, there is a possibility the U.S. could get stuck in a self-destructive circle: Big government deficits causing high interest rates and a strong dollar, which in turn cause a recession, which brings down interest rates and the dollar and boosts inflation and increases the federal deficit, which again pushes interest rates and the dollar up. Whether this grim scenario gets played out or whether the U.S. restores its international competitiveness over the forecast period, then, depends not only on what the exchange rate does and thus on what happens with the federal deficit.

If business investment and constrained labor costs are the key to international competitiveness, will the federal budget deficit allow interest rates and inflation to combine in a way to produce a leaner, more competitive U.S. manufacturing sector? As of this writing, the only thing certain about

the federal budget for 1986 is that nothing is certain. With the House and Senate alternately nixing each other's proposed spending cuts, it seems apparent that any real reduction in the federal budget deficit is not in the cards. It is currently projected that Congress will cut \$20 billion off the budget in fiscal 1986, and \$50 billion in fiscal 1987.

Hence, the crux of the forecast rests on the perhaps shaky assumption that over the long term, the federal deficit trends downward as a percent of GNP due to some action on the part of Congress. Under that assumption, the path of the prime interest rate over the forecast period should not deviate much outside the 9 to 11% range. (See Chart 7.) And with the consumer price index (CPI) not expected to run at rates much higher than 5% annually, real



interest rates should stay in the 4 to 6% range. With interest rates, both real and nominal, thus not expected to rise, business investment should be one of the strongest sectors of the economy. (See Chart 8.)

According to the forecast, business investment will increase at an average annual rate of 4.4% over the next ten years. That's in comparison to 3.8%

average annual increases from 1969 to 1984. In fact, it wasn't since the sixties that the growth in non-residential real fixed investment was so strong. (See Table I.)

There are several reasons why the long-term outlook for business investment is so favorable. Most visibly, the fierce competition from abroad is a major impetus for domestic manufacturers to increase productivity. (Even if the exchange rate fell to pre-catastrophe levels tomorrow, foreign producers would not easily part with the burgeoning market share they now control.)

Table I
Components of Real GNP

	History				Forecast 1984-1995		
	1949- <u>1959</u>	1959- <u>1969</u>	1969- <u>1979</u>	1979- <u>1984</u>	<u>Trend</u>	<u>Optimistic</u>	<u>Pessimistic</u>
GNP	3.9	4.2	3.1	2.1	2.9	3.5	2.4
Consumption	3.3	4.1	3.5	2.8	2.8	3.3	2.2
Nonres. Fixed Invest.	3.3	6.3	3.8	3.8	4.4	5.7	3.4
Res. Investment	4.6	1.5	3.1	0.4	1.1	1.8	0.4
Government Purchases	5.8	4.2	0.8	1.7	2.3	2.8	2.5
Net Exports	-12.9	-10.3	45.1	nm	nm	12.5	nm

And not only must domestic manufacturers gear up to beat overseas firms in their home market--they must play to win overseas as well. Additionally, another indicator of the strong potential for business investment is anticipated vigorous demand for durable goods--those most vulnerable to foreign competition. (See Section III.) One more reason is merely the aging and growing obsolescence of a massive amount of capital stock already in place. Demographics will also play an important role in business investment since growth in the labor force is expected to grow at a muted rate. (See Section III). If U.S. business even plans to keep production at its current rate with fewer people entering the work force, productivity per person will have to be increased by providing each person with more plant and equipment to work with.

The verdict on future U.S. manufacturing competitiveness, then, is that with the bright outlook for business investment, it is restorable--but only if the federal deficit doesn't step in and nip it in the bud via rising interest rates and a forever strengthening dollar.



Section III

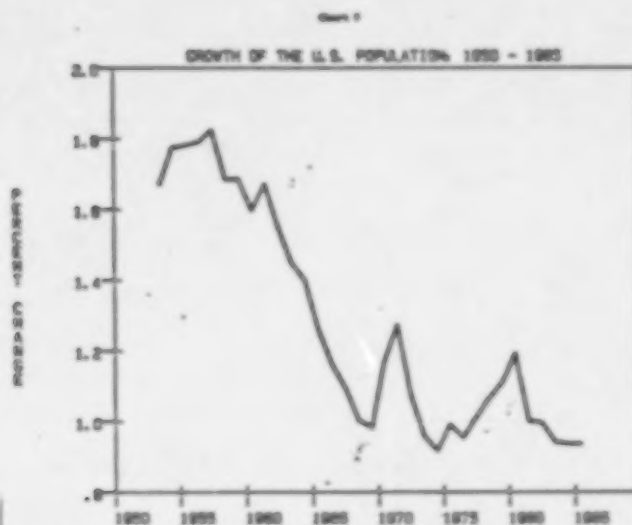
Demographic Trends: The Key to Future Industrial Prosperity--or Poverty

The pattern in which Americans are born, give birth, and die has a twofold effect on U.S. business. Not only does the rate of growth and composition of the population have important effects on the size, age, and level of education of the work force, but also on the consumer force. For example, the mini-baby boom generated by the original baby boomers is sparking exceptional growth in disposable diapers; the slowdown in the number of younger people in the 16-to-24-year-old range entering the work-force, however, may have a adverse impact on some other industries; and prolonged life spans and the proportionately increasing elderly population will put added pressure on the medical services and health care industries.

Other variables like differing income growth and propensity to consume among age groups also figure into the way changing demographic trends alter how America does business. For example, younger entrants to the work force tend to spend more than they earn (via credit cards, car loans, etc.) in anticipation of making more money later. Older workers reverse this trend with an eye toward financial security and retirement. The slowdown in the post-baby boom birthrate implies that younger workers aged 16 to 24 will be a slower growing part of the population while the post-55 age group will swell.

A number of factors have colluded to stem the U.S. birth rate since the baby boom busted in the early 1960s. They include the influx of women into the workforce, marriages postponed to later years--or never; a sky-high divorce rate; and simply, the exorbitant cost of raising children. While

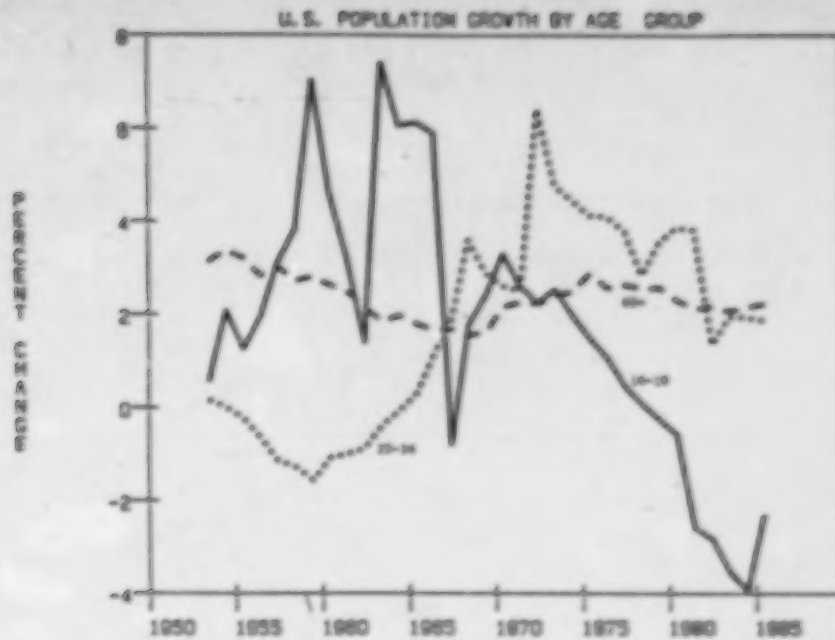
Overall population growth will slow down dramatically during the forecast period in comparison to the last ten years, even more of a slowdown is projected for the prime consumer group--adults. The adult population, after growing at a 1.9% annual rate in 1970s, will grow at a muted 0.8%-0.9% rate from 1985 to 1995. And as the post-baby boomers move through the 25-to-34 year-old cohort, the growth rate of the group will slow even more dramatically than any other group. (See Charts 9 and 10.)



In fact, the 25-34 age group that once moved at a 4.1% clip in the early 1970s, will actually decline about 0.3% annually over the next decade. The implications for the work force because of these developments are as follows:

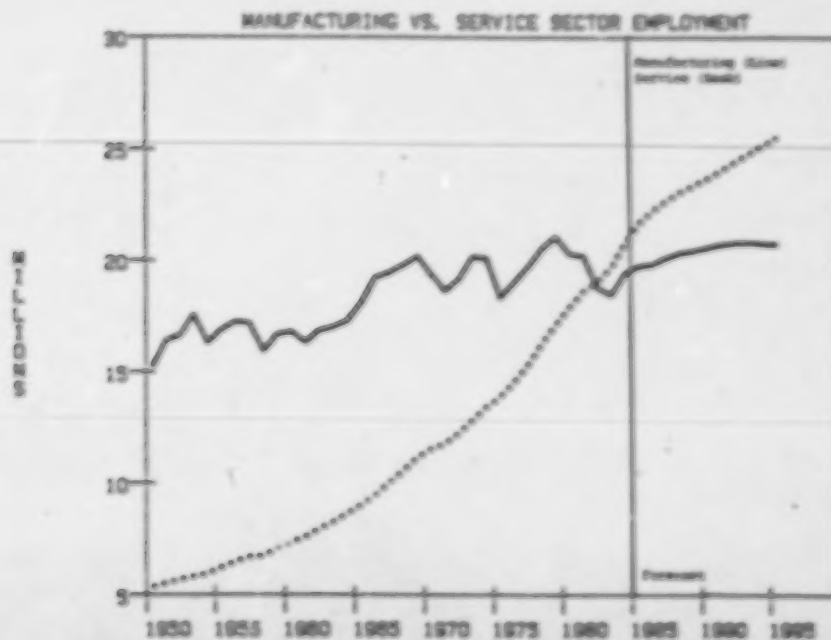
- *The total labor force will grow 1.3% annually during the next decade. That's way below the 2.2% growth rate between 1973 and 1984.
- *The composition of the work force will change in the way that the younger worker population (16-to-24) will fall while 25-to-54-year-old worker ranks will rise.

Chart 10



And not only will the composition of the labor force change; the kinds of work available will change as well. As recession, increased productivity, and increased foreign competition skimmed employment 0.3% annually from U.S. manufacturing plants over the past ten years, services hired workers at a 4.4% annual growth rate. And while manufacturing is expected to pick up some new employees over the next ten years as manufacturing itself picks up, service industries will do more hiring. (See Chart 11.)

Chart 11



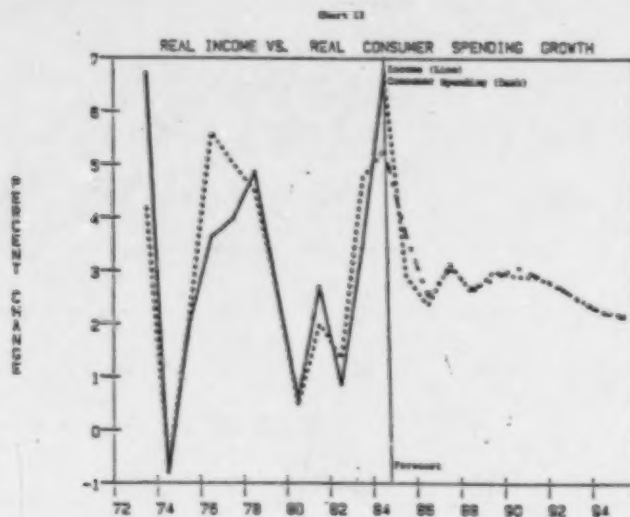
In fact, an estimated 66% of the new jobs generated over the next decade will be in services while manufacturing employment is slated to account for only about 6.6% of all new jobs.

This increased emphasis on mostly lower-paying service industry jobs coupled with a series of other factors will likely serve to slow up nominal wage growth to 6.9% over the forecast period as compared to 8.1% over the past decade. These factors include the slow demise in the effectiveness of unions, a level of unemployment that should prevent any wage demand excesses, and a more competitive environment due to imports and, in some cases, deregulation. In real terms, however, lower inflation and productivity gains will actually serve to beef up wage increases a bit.

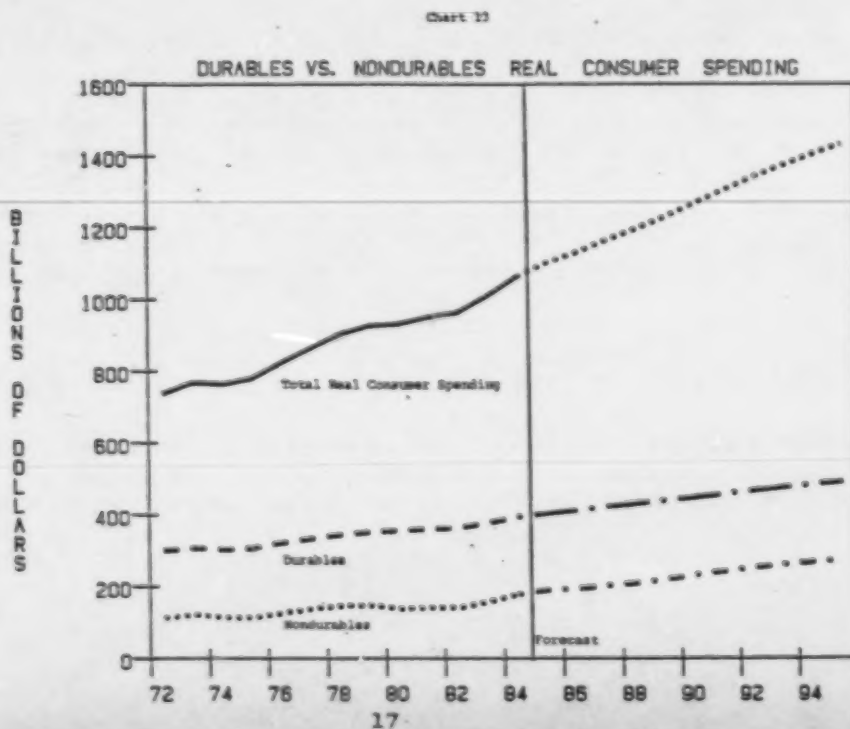
While real wage growth will be far from heady, in terms of real per capita income growth U.S. business will have more to go on in the next ten years than in the last ten years. Projected to rise an average of 1.8% annually from 1985 to 1995, real per capita income growth will substantially exceed the 1.1% rate of the past turbulent decade. However, it is significantly below the 2.8% rate enjoyed from 1962 to 1973.

Real consumer spending is forecast to outpace real income growth in the next decade. (See Chart 12.) Nevertheless, due to the slowdown in population growth it will proceed at a rate lower than in the past. According to the forecast, spending will advance at a 2.8% average annual rate through 1995. That compares to a 3% average rate from 1973 through 1984 and a 4.3% rate from 1962 through 1973. The component breakdown of real consumer spending is not radically different than in the past. Durable goods consumer spending traditionally grows at a faster rate than nondurables simply because food and clothing purchases rise with income only until a certain point, and then tail off. Spending on durable goods like autos and stereos, on the other hand, tends to accelerate during periods of rising income. From 1962-73, real

consumer spending on durables averaged 7.5% annual growth while nondurables spending could not achieve even half that rate. During the 1970s, exploding



energy prices, recession, and soaring inflation relegated growth in real durables spending to about 3.6%; nevertheless, nondurables spending growth averaged around only the 2.3% mark. And during the period from 1984 to 1995, durables spending growth should average about 4% annually while nondurables spending rises only about 2.1% a year. (See Chart 13.)

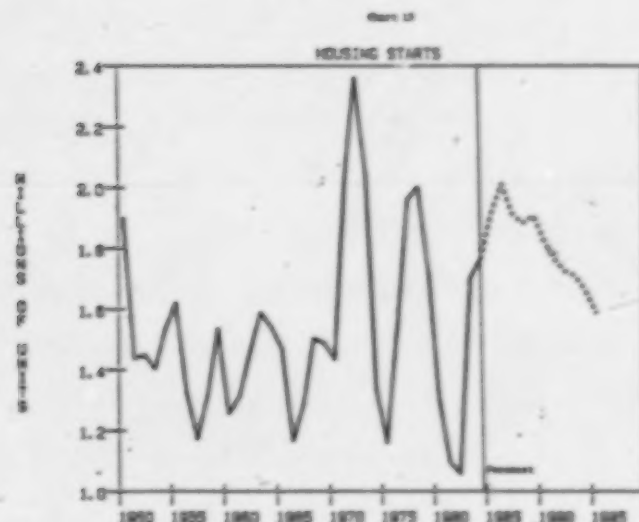
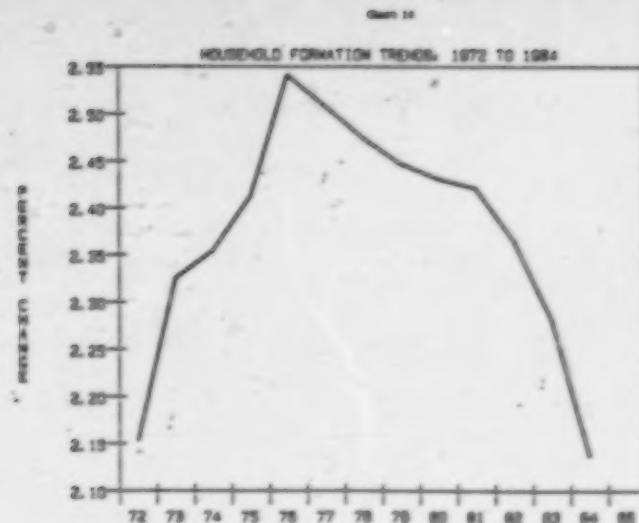


Service industry growth has slightly outpaced that of overall consumer spending during the past two decades, but increasing saturation of such markets will probably keep real spending on services neck and neck with total spending throughout the forecast period.

The aforementioned demographic, spending, and income trends coupled with foreign competition will help change the face of American industry over the 1985-95 forecast period. In the following pages, the implications of these variables for growth of individual U.S. industries are discussed.

Housing

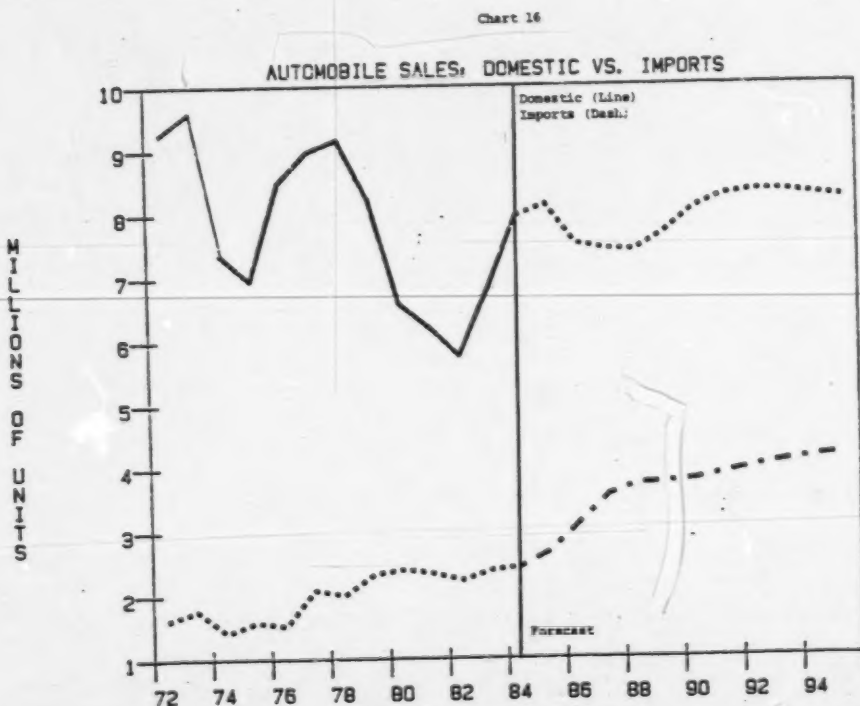
Initially, the first part of the long-term outlook for housing is an upper. Even though the adult population is growing at a much slower rate than in the past, the number of people in prime homebuying years will increase. (Pent-up demand could also support housing starts at a fairly boisterous level.) For example, in the 1960s, household formation grew at a 1.8% annual rate. In the 1970s, the surge of baby boomers into their twenties and early thirties pushed the household formation rate to 2.2% per year. In the early recession-ridden eighties, the household formation rate slumped to 1.3%. While divorces, postponed marriages, and the remaining bulge in the prime homebuying cohort should have kept new households skipping along, monstrous interest rates and inflation in home prices (along with everything else) kept spouses from moving out, singles from moving in, and new families from moving up. Hence, despite the 1983 to mid-1984 boom in housing, there appears to be quite a bit of leftover housing demand waiting for the right price and mortgage rate. (See Charts 14 and 15.)



Historically high mortgage rates and stiff price tags on new homes have been a wet blanket on housing for quite a while now, but starting in the 1990s, it will be an unfavorable demographic shift that hammers the lid on residential construction. The prime homebuying cohort between 25 and 34 years old is slated to peak at about 17.7% of the population in 1987. After that, a significant downward shift will occur, and the construction industry may just have to learn to be content with building second homes--and retirement homes.

Automobiles

Thanks to a bulge in the 20 to 39 year old prime auto-buying cohort, automobile sales (although not necessarily domestically-produced) will reach record highs during the next ten years. In fact, unit car sales are expected to average 11 million units through 1990 and over 12 million thereafter. (See Chart 15.) And because the latter part of the prime car-buying group will also be in the most affluent time period of their lives, the cars purchased will tend to be upscale models. While consumers will be doling out the cash at a healthy 3.6% annual rate (in real terms) for their favorite autos, however, the popularity of foreign cars makes the outlook for the domestic automobile industry not quite as salubrious: Industrial production for the U.S. automobile industry is forecast to rise only about 2.8% annually through 1995--not even outpacing the 3.4% average annual rise projected for overall industrial production.



Other Manufacturing

The high growth industries of the next decade are, not coincidentally, the high-tech industries. While a gadget-happy consumer will account for laser-fast sales of stereos, VCRs, telephone answering machines, and other necessary tools for everyday living, business investment will be the major force behind this anticipated growth.

Transportation equipment industries are expected to be among the winners in this capital spending spree, but the big thrust in business investment will be in factory automation. In fact, preliminary results from a McGraw-Hill Economics study on factory automation showed that a large percentage of industry spending on plant and equipment will go exclusively for automation purposes. The stars of this spending will be programmable controllers and computerized process control systems. Major introductions and cost breakthroughs are also expected in fiber optics, robotics, machine vision and artificial intelligence. Hence, expect the growth rates of instruments, nonelectrical machinery, and electrical machinery to outpace U.S. industry as a whole far into the foreseeable future. (See Chart 16.)

Rubber and plastics products are projected to lead all manufacturing in production growth because of their growing uses in all the aforementioned capital equipment markets. And chemical products are also expected to be big gainers over the next decade, but not only because of the industry's contribution to plastics manufacturing. Technological breakthroughs in biochemistry, regulatory breakthroughs in pharmaceutical testing, and the growing popularity of generic drugs will keep drug output up. (The expected rise in consumer spending on medical services vis-a-vis overall spending won't hurt either.) Even basic chemical production should regain vigor once the fall in the dollar takes away some of foreign producers' price advantages.

Chart 16

Gross Domestic Product by Industry
(Billions of 1972 Dollars)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Mining.....	\$22.4	\$22.6	\$23.2	\$23.6	\$23.7	\$23.8	\$24.0	\$24.1	\$24.2	\$24.2	\$24.2	\$24.2
Construction.....	55.3	56.5	57.5	58.9	60.0	61.5	62.5	63.4	64.2	65.3	66.3	67.0
Manufacturing.....	391.8	401.4	412.7	431.1	449.7	465.7	484.3	501.8	516.4	529.3	540.8	553.0
Nondurables Manufacturing.....	153.8	155.2	159.2	165.5	170.9	176.3	182.0	187.7	192.8	197.1	201.0	205.0
Food and Products.....	34.4	35.2	36.0	37.1	38.1	39.2	40.3	41.3	42.2	43.1	43.9	44.6
Tobacco Products.....	3.5	3.5	3.5	3.5	3.6	3.6	3.7	3.7	3.8	3.9	3.9	4.0
Textile Mill Products.....	11.5	11.2	11.6	12.2	12.5	12.8	13.2	13.6	13.8	13.9	14.0	14.1
Apparel and Products.....	13.3	13.4	13.6	14.1	14.4	14.6	14.9	15.1	15.3	15.4	15.5	15.6
Paper and Products.....	15.4	15.5	15.7	16.3	16.8	17.3	17.8	18.4	18.9	19.2	19.6	19.9
Printing and Publishing.....	20.3	20.8	21.2	21.7	22.1	22.6	23.1	23.6	24.0	24.3	24.7	25.0
Chemicals and Products.....	31.1	31.3	32.5	34.3	36.2	38.0	40.0	42.0	44.0	45.8	47.3	49.0
Petroleum Products.....	8.0	7.9	8.2	8.4	8.5	8.6	8.7	8.8	8.9	9.0	9.1	9.2
Rubber and Plastics Products.....	14.3	14.5	15.0	16.0	16.7	17.5	18.3	19.1	19.8	20.4	21.0	21.5
Leather and Products.....	2.0	1.9	1.8	1.9	2.0	2.0	2.0	2.1	2.1	2.1	2.1	2.1
Durables Manufacturing.....	237.9	246.2	253.6	265.5	278.8	289.5	302.3	314.1	323.6	332.2	339.8	348.0
Lumber and Wood Products.....	13.4	13.7	14.3	14.8	15.2	15.9	16.1	16.5	16.8	17.4	17.7	17.8
Furniture and Fixtures.....	6.2	6.3	6.4	6.7	6.9	7.0	7.2	7.4	7.6	7.8	8.0	8.1
Stone, Clay, and Glass.....	10.6	11.0	11.3	11.5	11.8	12.2	12.8	13.3	13.6	13.9	14.2	14.3
Primary Metals.....	17.1	17.0	17.8	18.6	19.2	19.9	20.8	21.4	21.7	21.9	21.9	22.0
Fabricated Metal Products.....	26.0	26.9	27.3	28.5	29.8	30.8	31.9	32.9	33.9	34.8	35.4	36.0
Nonelectrical Machinery.....	48.2	50.7	52.9	55.5	58.7	61.1	64.1	67.2	70.0	72.7	75.4	78.3
Electrical Machinery.....	49.5	50.8	53.8	57.9	61.3	63.6	66.2	68.8	70.7	72.2	73.8	76.0
Transportation Equipment.....	47.4	49.7	49.1	50.1	53.2	55.3	58.7	61.3	63.0	64.5	65.7	67.0
Instruments.....	14.1	14.6	15.2	15.9	16.7	17.4	18.2	18.9	19.5	20.1	20.7	21.2
Miscellaneous Manufactures.....	5.4	5.4	5.6	5.8	6.0	6.2	6.4	6.6	6.8	6.9	7.1	7.3
Transportation and Public Utilities	147.7	151.6	156.5	162.6	167.7	173.4	178.9	184.1	188.7	192.9	196.7	200.6
Trade.....	282.2	295.1	304.1	315.3	324.5	334.3	345.7	357.2	368.2	378.1	387.4	396.8
Finance, Insurance and Real Estate.	277.5	289.8	298.9	310.3	320.0	332.5	343.5	354.0	365.2	376.0	386.0	395.2
Services.....	212.6	221.2	227.2	235.0	242.4	250.0	258.3	267.3	275.0	282.3	289.1	295.9
Gov't and Gov't Enterprises.....	180.6	184.0	187.5	191.6	197.4	202.2	207.8	212.9	217.9	223.0	228.9	234.7

The future economy's less ostentatious performers will revolve more around the consumer. Moderately healthy residential construction prospects should keep stone, clay and glass, and furniture and fixture production not too far below the U.S. industrial average. And industrial production in food, beverages, and paper products should keep up with growth in real consumer spending on nondurables since these markets are rarely infringed upon to any great extent by foreign imports.

The real losers in the economy of the next ten years will be those mostly nondurables industries prone to extensive import penetration even before the dollar's space flight. These include textiles, apparel, and leather goods such as shoes and handbags. In addition, the high labor cost and lower value-added component of natural resource industries such as mining and lumber--especially in the face of cheaper imports--will substantially stunt production of such products over the next decade. The pitiful production plight of the petroleum industry also will remain in the next decade as conservation efforts, strides in energy efficiency, and OPEC infighting and price cutting remain on center stage.

Section IV

The Alternative Scenarios

While the movement of the U.S. economy usually follows previously paved paths and is consequently predictable within a certain degree of error, deviations from historically established trends and relationships are not uncommon either. Hence, two other scenarios with some degree of probability have been formulated to capture both overly optimistic or pessimistic assumptions about certain economic variables.

The centerpiece assumptions in the optimistic scenario that differ from the trend forecasts concern the federal deficit and growth in the labor force. In the perhaps idealistic assumption that Congress gets its act together and passes a deficit reduction package with \$30 billion worth of spending cuts in 1986 and \$70 billion in fiscal 1987, interest rates will be significantly lower than currently expected. The hope in terms of the labor force in the optimistic scenario is that women increase their labor participation rate, and that the rate of black male employment begins to converge with that of white males. Combined, these developments would increase growth in the labor force and in business investment, hence, in potential output. Lower interest rates would strengthen consumer spending on durables, improve the exchange rate and thus liven up U.S. industrial production to a substantially higher rate than now projected.

On the darker side of potential economic developments, the pessimistic forecast assumes that the federal deficit continues to mushroom and the labor force does not get the benefit of increased female and black participation. Interest rates rise and remain higher than in the trend projection; the balance of trade does not recover as much; and investment, productivity, and

potential output in the economy stagnates. Accordingly, incomes and consumer spending ebb lower. And because of higher interest rates, the more discretionary consumption expenditures that don't go to nondurable necessities will go to the less productive service industry rather than durable goods.

The chart below compares the parameters consistent with all three economic scenarios.

MIDDLE-OF-THE-ROAD FORECAST

	-----Billions of Dollars-----			-----Billions of 1972 Dollars-----			
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Inflation (GNP Deflator, 1972=100)
1950	286.5	192.0	27.3	534.8	337.3	50.0	0.535
1960	506.5	324.9	48.5	737.2	452.0	66.9	0.687
1970	992.7	621.7	103.9	1,085.6	672.1	113.9	0.914
1971	1,077.7	672.2	107.9	1,122.4	696.8	112.2	0.960
1972	1,185.9	737.0	121.0	1,185.9	737.0	121.0	1.000
1973	1,326.4	812.0	143.3	1,254.3	767.9	138.1	1.057
1974	1,434.2	888.1	156.6	1,246.3	762.8	135.7	1.151
1975	1,549.2	976.4	157.8	1,231.7	779.4	119.3	1.257
1976	1,718.0	1,084.3	174.1	1,298.2	823.1	125.6	1.323
1977	1,918.3	1,204.5	205.3	1,369.7	864.4	140.3	1.400
1978	2,163.8	1,346.5	248.9	1,438.5	903.2	158.3	1.504
1979	2,417.8	1,507.2	290.2	1,479.4	927.6	170.0	1.634
1980	2,631.7	1,668.1	308.8	1,475.0	931.8	165.8	1.784
1981	2,957.8	1,849.1	353.9	1,512.2	950.4	175.0	1.956
1982	3,069.2	1,984.9	349.6	1,480.0	963.3	166.9	2.074
1983	3,304.8	2,155.9	352.9	1,534.7	1,009.2	171.0	2.153
<u>Forecast</u>							
1984	3,662.8	2,341.8	425.7	1,639.3	1,062.4	204.9	2.234
1985	3,901.2	2,504.0	463.5	1,684.2	1,101.4	217.8	2.316
1986	4,140.8	2,662.9	493.2	1,726.5	1,129.4	225.0	2.398
1987	4,484.5	2,864.9	561.0	1,791.0	1,163.9	245.0	2.504
1988	4,855.3	3,086.6	624.7	1,847.4	1,195.1	260.0	2.628
1989	5,262.7	3,331.1	678.6	1,906.5	1,229.3	269.5	2.760
1990	5,714.9	3,608.9	739.5	1,969.2	1,267.2	279.7	2.902
1991	6,206.3	3,909.7	804.9	2,029.5	1,304.0	289.5	3.058
1992	6,732.6	4,232.2	875.1	2,085.9	1,339.2	299.7	3.227
1993	7,295.4	4,578.0	952.3	2,138.9	1,371.7	310.1	3.410
1994	7,900.3	4,950.1	1,034.1	2,189.1	1,402.1	319.8	3.609
1995	8,560.2	5,355.9	1,120.7	2,239.3	1,432.0	328.9	3.822

MIDDLE-OF-THE-ROAD-FORECAST

	<u>Industrial Production</u> (Index, 1977=100)	<u>Population</u> (Millions)	<u>Housing Starts</u> (Thousands)	<u>Civilian Employment</u> (Millions)
1950	0.449	161.019	1.899	58.892
1960	0.661	180.671	1.256	65.785
1970	1.078	205.052	1.435	78.669
1971	1.096	207.661	2.036	79.355
1972	1.197	209.896	2.361	82.135
1973	1.297	211.909	2.044	85.051
1974	1.293	213.854	1.332	86.803
1975	1.178	215.973	1.160	85.830
1976	1.304	218.035	1.535	88.753
1977	1.381	220.239	1.962	92.017
1978	1.461	222.585	2.001	96.046
1979	1.525	225.055	1.717	98.825
1980	1.470	227.738	1.300	99.303
1981	1.509	230.019	1.096	100.397
1982	1.386	232.309	1.057	99.527
1983	1.476	234.496	1.703	100.822
1984	1.633	236.692	1.766	105.003

Forecast

1985	1.668	238.909	1.916	107.412
1986	1.716	241.137	2.012	108.774
1987	1.800	243.367	1.913	111.156
1988	1.875	245.588	1.882	113.134
1989	1.951	247.786	1.908	114.587
1990	2.036	249.948	1.825	116.056
1991	2.117	252.060	1.764	117.466
1992	2.187	254.113	1.725	118.741
1993	2.249	256.098	1.709	119.955
1994	2.305	258.014	1.657	121.078
1995	2.365	259.862	1.588	122.259

-----Billions of Dollars-----				-----Billions of 1972 Dollars-----			
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Inflation (GNP Deflator, 1972=100)
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1984	3,662.8	2,341.8	425.7	1,639.3	1,062.4	204.9	2.234
Forecast							
1985	3,900.7	2,504.3	463.3	1,684.2	1,101.8	217.8	2.310
1986	4,145.9	2,668.0	490.6	1,727.6	1,132.4	225.3	2.370
1987	4,505.4	2,875.3	550.5	1,795.1	1,169.0	242.1	2.456
1988	4,918.8	3,117.9	615.8	1,852.7	1,199.5	256.6	2.557
1989	5,365.7	3,384.1	675.0	1,898.4	1,223.7	265.0	2.665
1990	5,866.2	3,689.5	740.1	1,944.2	1,249.7	272.7	2.779
1991	6,415.8	4,025.1	806.8	1,986.8	1,274.3	278.6	2.902
1992	7,017.6	4,396.2	877.6	2,026.4	1,298.7	284.3	3.030
1993	7,669.4	4,799.3	955.0	2,061.2	1,319.5	289.5	3.165
1994	8,378.3	5,236.5	1,037.0	2,092.6	1,337.6	294.0	3.308
1995	9,154.5	5,715.1	1,123.1	2,123.4	1,354.7	297.4	3.460

OPTIMISTIC FORECAST

	<u>Industrial Production</u> (Index, 1977=100)	<u>Population</u> (Millions)	<u>Housing Starts</u> (Thousands)	<u>Civilian Employment</u> (Millions)
1950	0.449	161.019	1.099	58.892
1960	0.661	180.671	1.256	65.785
1970	1.078	205.052	1.435	78.669
1971	1.096	207.661	2.036	79.355
1972	1.197	209.896	2.361	82.135
1973	1.297	211.909	2.044	85.051
1974	1.293	213.854	1.332	86.803
1975	1.178	215.973	1.160	85.830
1976	1.304	218.035	1.535	88.753
1977	1.381	220.239	1.962	92.017
1978	1.461	222.585	2.001	96.046
1979	1.525	225.055	1.717	98.825
1980	1.470	227.738	1.300	99.303
1981	1.509	230.019	1.096	100.397
1982	1.386	232.309	1.057	99.527
1983	1.476	234.496	1.703	100.822
1984	1.633	236.692	1.766	105.003
<u>Forecast</u>				
1985	1.677	238.909	1.943	107.850
1986	1.776	241.137	2.134	110.636
1987	1.886	243.367	2.071	113.909
1988	1.989	245.588	2.075	116.577
1989	2.073	247.786	2.016	118.447
1990	2.171	249.948	1.938	120.302
1991	2.269	252.060	1.905	122.186
1992	2.356	254.113	1.882	123.955
1993	2.436	256.098	1.878	125.675
1994	2.514	258.014	1.846	127.329
1995	2.594	259.862	1.783	129.073

PESSIMISTIC FORECAST

-----Billions of Dollars-----					-----Billions of 1972 Dollars-----				
	Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment		Gross National Product	Personal Consumption Expenditures	Nonresidential Fixed Investment	Inflation (GDP Deflator, 1972=100)	
1950	286.5	192.0	27.3		534.0	337.3	50.0	0.935	
1960	506.5	324.9	48.5		737.2	452.0	66.9	0.687	
1970	992.7	621.7	103.9		1,085.6	672.1	113.9	0.914	
1971	1,077.7	672.2	107.9		1,122.4	696.0	112.2	0.960	
1972	1,185.9	737.0	121.0		1,185.9	737.0	121.0	1.000	
1973	1,326.4	812.0	143.3		1,254.3	767.9	138.1	1.057	
1974	1,434.2	888.1	156.6		1,246.3	762.8	135.7	1.151	
1975	1,549.2	976.4	157.8		1,231.7	779.4	119.3	1.257	
1976	1,718.0	1,084.3	174.1		1,298.2	823.1	125.6	1.323	
1977	1,918.3	1,204.5	205.3		1,369.7	864.4	140.3	1.400	
1978	2,163.8	1,346.5	248.9		1,438.5	903.2	158.3	1.504	
1979	2,417.8	1,507.2	290.2		1,479.4	927.6	170.0	1.634	
1980	2,631.7	1,668.1	308.8		1,475.0	931.8	165.8	1.784	
1981	2,957.8	1,849.1	353.9		1,512.2	950.4	175.0	1.956	
1982	3,069.2	1,984.9	349.6		1,480.0	963.3	166.9	2.074	
1983	3,304.8	2,155.9	352.9		1,534.7	1,009.2	171.0	2.153	
1984	3,662.8	2,341.8	425.7		1,639.3	1,062.4	204.9	2.234	
<u>Forecast</u>									
1985	3,899.2	2,501.1	466.9		1,688.0	1,103.0	219.4	2.316	
1986	4,159.3	2,656.9	517.3		1,755.1	1,139.0	235.7	2.400	
1987	4,509.5	2,846.0	591.2		1,836.2	1,180.6	259.3	2.509	
1988	4,884.7	3,050.3	672.8		1,910.2	1,218.6	282.7	2.655	
1989	5,271.6	3,277.3	737.8		1,978.1	1,258.3	297.3	2.826	
1990	5,701.2	3,533.9	805.9		2,051.4	1,302.6	311.8	3.017	
1991	6,168.8	3,815.2	877.4		2,125.7	1,348.9	326.6	3.229	
1992	6,657.1	4,115.7	951.9		2,196.9	1,395.0	341.3	3.463	
1993	7,170.8	4,434.0	1,027.3		2,265.3	1,439.1	354.6	3.720	
1994	7,735.3	4,773.5	1,103.8		2,332.0	1,482.2	366.8	4.003	
1995	8,303.4	5,139.8	1,184.8		2,399.4	1,525.0	378.8	4.311	

PESSIMISTIC FORECAST

	<u>Industrial Production</u> (Index, 1977=100)	<u>Population</u> (Millions)	<u>Housing Starts</u> (Thousands)	<u>Civilian Employment</u> (Millions)
1950	0.449	161.019	1.899	58.892
1960	0.661	180.671	1.256	65.785
1970	1.078	205.052	1.435	78.669
1971	1.096	207.661	2.036	79.355
1972	1.197	209.896	2.361	82.135
1973	1.297	211.909	2.044	85.051
1974	1.293	213.854	1.332	86.803
1975	1.178	215.973	1.160	85.830
1976	1.304	218.035	1.535	88.753
1977	1.381	220.239	1.962	92.017
1978	1.461	222.585	2.001	96.046
1979	1.525	225.055	1.717	98.825
1980	1.470	227.738	1.300	99.303
1981	1.509	230.019	1.096	100.397
1982	1.386	232.309	1.057	99.527
1983	1.476	234.496	1.703	100.822
1984	1.633	236.692	1.766	105.003
<u>Forecast</u>				
1985	1.668	238.909	1.897	107.408
1986	1.713	241.137	1.899	108.776
1987	1.797	243.367	1.867	111.159
1988	1.877	245.588	1.868	112.751
1989	1.933	247.786	1.851	113.266
1990	1.993	249.948	1.748	113.762
1991	2.048	252.060	1.689	114.237
1992	2.094	254.113	1.632	114.648
1993	2.129	256.098	1.591	115.013
1994	2.157	258.014	1.528	115.310
1995	2.189	259.862	1.445	115.679